
7700 SPECIAL FORMULAS AND INDUSTRIES WITH UNIQUE APPORTIONMENT PROBLEMS

In cases where the standard apportionment provisions will not fairly represent the taxpayer's business activities within the state, R&TC §25137 permits a departure from the standard formula. Such a departure may be separate accounting, the exclusion of one or more of the factors, the inclusion of one or more additional factors, or the employment of any other method which will result in fair apportionment and allocation of the taxpayer's income to this state.

Special procedures have been established in the regulations for certain industries and types of transactions where the FTB has determined that the standard apportionment formula will not produce appropriate results. The special formulas are contained in CCR §25137 through CCR §25137-11 and CCR §25101.

There are additional industries and types of transactions that present unique apportionment problems, but for which specific solutions are not set forth in the Regulations. The department has developed apportionment procedures to deal with these situations. Since these procedures are not found in the law or regulations, it is important for auditors who are proposing to use these rules to clearly communicate to the taxpayers the distortion or unclear reflection of activities within the state that occur when the special methods are not applied, and to cite R&TC §25137 as our authority for deviating from the standard apportionment rules to correct those problems. The areas where the department has developed special apportionment procedures are bus transportation, freight forwarding companies, mining, printers, professional sports, oil and gas industry, stockbrokers, telecommunications companies, timber, and vessels such as tug boats, barges, etc.

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7701 APPLICATION OF CCR §25137 IN GENERAL

R&TC Section 25137 permits a departure from the standard allocation and apportionment provisions only in limited and specific cases where the standard formula produces incongruous results. CCR §25137 recognize that the standard apportionment provisions are not appropriate when applied to certain industries and types of transactions, and provide special apportionment procedures for those situations. In the *Appeal of Fluor Corporation*, Cal. St. Bd. of Equal., December 12, 1995, the SBE clarified the role of the special formulas provided by the regulations:

General Rule	Unless . . .	In Which Case . .
Both the taxpayer and FTB are required to use the standard apportionment and allocation rules under UDITPA.	The party seeking to deviate from the standard formula establishes by clear and convincing evidence that the standard formula does not fairly represent the extent of the taxpayer's activities in the state.	The formula may be modified to reflect a method which will result in fair apportionment.
	<i>or</i>	Unless . . .
	The taxpayer's situation satisfies the conditions and circumstances provided for in Regulations §§ 25137 - 25137-11 and §25101.	Both the taxpayer and FTB are required to use the method prescribed by the regulations.
		In Which Case . .
		The party seeking to deviate from the regulations establishes by clear and convincing evidence that the method in the regulations does not fairly represent the extent of the taxpayer's activities in the state.
		The formula may be modified to reflect a method (including the standard UDITPA formula) which will result in fair apportionment.

The significance of the SBE's holding in *Fluor* was that as long as the taxpayer's circumstances satisfied the terms and conditions provided in CCR §25137, neither the taxpayer nor the FTB had to prove distortion in order to apply the special formula prescribed by the regulations. Prior to the *Fluor* decision, the SBE's decision in *Appeal of Triangle Publications, Inc.* (Cal. St. Bd. of Equal., June 27, 1984) had stated that the FTB could not apply the apportionment procedures specified in CCR §25137(c)(1)(A) without first establishing that the standard formula would not result in fair apportionment because of the taxpayer's exceptional circumstances. To the extent that the opinion in *Triangle Publications* conflicts with the decision expressed in *Fluor*, the *Triangle Publications* decision was overruled.

The *Fluor* decision also recognized that even if a taxpayer meets the terms and conditions for applying a special formula prescribed by CCR §25137, situations may arise where application of the

special formula will not fairly represent the taxpayer's activities within the state. Therefore, either the taxpayer or the FTB may deviate from the method prescribed by the regulations if they can establish distortion.

CCR §25137(b) and CCR §25137(c) provide special apportionment rules to correct specific property and sales factor problems. These rules are covered in MATM 7134 (property factor) and MATM 7512 - MATM 7516 (sales factor). CCR §25137-1 through CCR §25137-12 provide apportionment rules for certain industries and types of transactions. In addition, CCR §25101 provides apportionment rules for the sea transportation business. These special formulas are discussed in MATM 7705 through MATM 7760. The department has identified several other industries that present unique apportionment problems, and has developed apportionment procedures to deal with those situations. These apportionment procedures are discussed in MATM 7765 through MATM 7815, but are only intended as guidance for auditors seeking to correct distortion problems. Because these procedures are not found in the regulations, an auditor can not force a taxpayer to apply the special rules without first establishing that application of the standard formula does not clearly reflect the business activities within California.

R&TC Section 25137 provides that a taxpayer may petition for the Franchise Tax Board to allow a departure from the standard formula. In order for relief to be granted under R&TC §25137, the problem identified by the taxpayer must be a result of the apportionment and allocation provisions set forth in R&TC §25120 - R&TC §25139. R&TC Section 25137 does not operate as a cure for other alleged inequities created by other provisions of the Revenue and Taxation Code. (*Appeal of CTI Holdings*, Cal. St. Bd. of Equal., February 22, 1996.)

The department will broadly interpret that an issue comes within R&TC §25137, although judgement is to be used. Each taxpayer and each year will be evaluated on its own unique set of facts and circumstances to determine if a R&TC §25137 issue exists. Any time a taxpayer, or an auditor, deviates from the standard allocation and apportionment rules established by R&TC §25120 through R&TC §25137, and the regulations adopted pursuant thereto, a potential R&TC §25137 issue exists.

To ensure consistent treatment of similarly situated taxpayers, all audit staff recommendations regarding the use of R&TC §25137 are to be forwarded to the Multistate Audit Specialist. The Multistate Audit Specialist will review the file to ensure that the issue is factually developed. The Multistate Audit Specialist will route the file with his/her recommendation to the Legal Division R&TC §25137 Petition Coordinator.

The R&TC §25137 Petition Coordinator will be responsible for reviewing the petition, coordinating staff's recommendation, submitting the appropriate information to the three member FTB, and other duties. The taxpayer has the right to request the three member FTB to review the petition.

What is distortion?

The apportionment formula is a method for approximating a taxpayer's California source income. Because methods of apportioning income are just an approximation, such methods will not be considered to be distortive just because another method may produce a slightly better result. In order for the standard apportionment formula (or a modified formula described in CCR §25137) to be set aside, it must be shown to produce an unreasonable result. There are no bright-line tests for determining whether distortion is present, so determinations of distortion must be based on the unique facts and circumstances of each case. Auditors should consider whether changes in the apportionment factors are significant in relation to the overall factor. It is also helpful to look beyond the numbers and consider whether the purpose for the individual apportionment factors is being met. The following cases may be looked to for guidance:

In *The Appeal of Pacific Telephone and Telegraph Company*, Cal. St. Bd. of Equal., May 4, 1978, several of the companies in the unitary group maintained pools of working capital which were invested in short-term securities. The largest of these pools was located in New York. Because of the turnover of the securities, *gross receipts* from the investments averaged 36% of the total gross receipts from all unitary activities, but the *income* generated by the investments was less than 2% of total unitary business income. Arguing that the standard formula resulted in unreasonable apportionment of income from the taxpayer's communications business, FTB sought to deviate from the standard formula by including the net income (rather than the gross receipts) from the investment activities in the sales factor.

The SBE allowed FTB's modification to the formula. They concluded that the standard UDITPA provisions did not fairly represent the extent of the taxpayer's business activities within the state as evidenced by the fact that an incidental part of the business caused 11% of The Bell System's entire unitary business activities to be attributed to New York.

In *Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, Cal. St. Bd. of Equal., June 2, 1989, the taxpayer conducted a securities trading business. Its California activities consisted primarily of brokerage sales in which the taxpayer earned commission income from the buying and selling of securities for customers. The taxpayer also traded in securities as a principle or underwriter, purchasing securities for its own account and remarketing them. Unlike the commission income, the gross receipts from the principle and underwriting transactions included the underlying cost of the security. Most of these transactions were conducted in New York, so were reflected only in the denominator of the sales factor.

The FTB's position was that the principle and underwriting transactions were virtually identical to the brokerage transactions, and that applying the standard formula to those transactions would have the effect of overweighting the sales in the denominator and underweighting sales in the numerator. Reasoning that both types of transactions should reflect similar weight in the formula, FTB adjusted

the sales factor to use gross profits (rather than gross receipts) to reflect the principle and underwriting transactions. The SBE did not agree that the two types of transactions were identical, and held that FTB had not met the burden of proving that the statutory apportionment provisions did not fairly reflect the business activity in this state.

Of importance in this case is the SBE's finding that distortion in one factor does not necessarily result in unfair reflection of the business activity within the state; the other two factors may mitigate the distortive effect of the third. Whether the apportionment formula produces an unreasonable result will depend upon the ultimate distortive effect that occurs when all three factors are considered in combination. In this case, the deviations from the standard formula proposed by the FTB revised the overall apportionment percentage from 3.4323 to 5.8637 in the year of the largest difference. The percentage difference for the appeal years was a 23% to 36% average increase in the apportionment formula. The SBE held that this difference was much too slight to justify application of R&TC §25137.

The differences in fact patterns may have led to the contrasting results in the *Pacific Telephone* and *Merrill Lynch* decisions. In *Pacific Telephone*, the treasury activities were only an incidental part of the business, yet if the standard formula were applied, the receipts from those activities would have significantly affected the apportionment of income from the primary business activity. In *Merrill Lynch*, the underwriting transactions constituted one of the taxpayer's two primary activities, and could therefore be expected to significantly affect the overall apportionment. FTB was not able to demonstrate why the apportionment results in *Merrill Lynch* were not reasonable.

In *The Appeal of New York Football Giants, Inc., Opn. on Pet. Rhg.*, Cal. St. Bd. of Equal., June 28, 1979, the issue involved whether FTB properly deviated from the standard formula by excluding from the sales factor the portion of the taxpayer's gate receipts that they were obligated to turn over to the visiting teams under NFL by-laws. Although the SBE acknowledged that FTB's approach was reasonable and perhaps even superior to the standard sales factor, they held that deviations from the normal rules are not authorized unless it is established that the UDITPA formula does not fairly represent the extent of the taxpayer's business activity in this state. A change in the sales factor from 4.08% to 5.71% was not found to be distortive.

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7705 PARTNERSHIP INCOME**CCR §25137-1**

The rules for apportionment and allocation of partnership income are found in CCR §25137-1. In general, if a member of a combined reporting group is a partner in a partnership, and the partnership's activities are unitary with the activities of the combined reporting group under established standards (disregarding the ownership requirement), then the partner's share of the partnership's property, payroll and sales will be included in the apportionment factors. Further discussion of this issue, as well as examples illustrating the application of this regulation can be found in MATM 7195 (Partnership Property), MATM 7360 (Partnership Payroll) and MATM 7570 (Partnership Sales).

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7710 LONG-TERM CONTRACTS**CCR §25137-2**

CCR §25137-2 sets forth the rules for apportioning income from long-term contracts. (Rules for partnerships engaged in long-term contracts are found in CCR §25137-1(h).) At the time the regulation was written, taxpayers were allowed to elect either the percentage of completion method or the completed contract method for reporting the income from the contract. Since that time, the rules for long-term contracts have been substantially revised, and the completed contract method has been substantially phased out. Although the regulation will still apply with respect to contracts using the percentage of completion method, the application of the regulation provisions concerning the completed contract method will become much more limited.

The first step in dealing with the issue of long-term contracts is to determine which set of rules applies to the contracts. For contracts entered into on or before February 28, 1986, taxpayers were allowed to elect either the percentage of completion method or the completed contract method. Under the percentage of completion method, gross income from a long-term contract was reported annually according to the percentage of the contract that was completed during that year. The taxpayer was allowed to compute the appropriate percentage based upon either the percentage of total estimated contract costs incurred, or the percentage of total estimated work performed. If the completed contract method were used, the net profit from the entire job would be reported in the year in which the contract was completed and accepted.

For contracts entered into after February 28, 1986, IRC §460 was amended to provide that (1) under the percentage of completion method, the appropriate percentage must be computed by comparing the construction costs incurred over the total estimated construction costs (the computation based upon percentage of work performed was no longer allowed); and (2) any contracts not accounted for under the percentage of completion method must use the "percentage-of-completion-capitalized-cost method." Percentage-of-completion-capitalized-cost was a hybrid method, which allowed the taxpayer to account for 60% of the net income from a contract under their normal method (such as the completed contract method) and the remaining 40% of the contract under the percentage of completion method.

In addition, any portion of a contract that was accounted for using the percentage of completion method would be subject to a "lookback" rule. The lookback provision under IRC §460 is applied at the completion of the contract, and requires the taxpayer to compute the amount of tax that should have been reported in each year on the percentage-of-completion portion of the contract based upon the actual costs incurred each year in relation to the total actual contract costs. To the extent the recomputed income differs from the income that was reported based upon estimated construction

costs, interest adjustments must be made. The taxpayer will be subject to interest on underreported amounts and will receive interest on overreported amounts.

California conformed to these federal changes for taxable years beginning on or after January 1, 1987 (R&TC §24673.2).

Subsequent revisions to federal law were made to adjust the percentage of the contract required to be reported using the percentage of completion method from 40% to 70% for contracts entered into after October 13, 1987; to 90% for contracts entered into after June 20, 1988. Most long-term contracts executed after July 10, 1989 must be fully accounted for under the percentage of completion method, although certain exceptions are made for small construction contracts and residential construction contracts. California incorporated these changes for taxable years beginning on or after January 1, 1990. For California purposes, contracts outstanding on January 1, 1990 would become subject to the federal rules in effect as of the date that the contract was entered into. The conformity provisions provide that adjustments to correct any overreporting or underreporting of income resulting from the change in the method of reporting the contracts shall be made in the year that the contract is completed.

Note: The regulation does not reflect the federal changes, which California conformed to for taxable years beginning on or after 1/1/87 nor does the regulation reflect subsequent revisions to federal law, which California conformed to for taxable years beginning on or after 1/1/90. Furthermore, the regulation does not make mention of double-weighting the sales factor for taxable years beginning on or after 1/1/93, but continues with a single-weighted sales factor for apportioning income from long-term contracts.

The percentage of completion method is generally required for book purposes. Therefore, adjustments on Schedule M-1 will be present if the taxpayer is using any other method for federal purposes. If the federal method has not been followed for California purposes, state adjustments will be present. Since more than one method may have been used during the transitional period, it may be necessary to analyze the taxpayer's workpapers to determine whether the appropriate method has been used based upon the date of each contract. Once the auditor is satisfied that the income has been correctly reported, the apportionment factors may be reviewed.

Property Factor:

COSTS IN EXCESS OF PROGRESS BILLINGS: Capitalized costs of construction are only included in the property factor to the extent that they exceed progress billings accrued (or received for cash basis taxpayers) under the contract. The excess of construction costs over the progress billings reflects the taxpayer's net investment or equity interest in the contract. If progress billings exceed construction costs, they will not be reflected in the factor because they will reflect a liability rather than

an investment. Each contract must be treated separately; excess costs on one contract may not be offset against excess billings on another contract.

Example: The taxpayer's costs attributable to the contract are \$1,000,000 at the end of the first year. The client has been billed for \$600,000. The net difference of \$400,000 should be included in the property factor. The excess costs may not be netted against other contracts with billings in excess of costs. A continuation of this example illustrating the treatment of excess costs in the second year of this contract may be found in CCR §25137-2(d)(4)(A).

Some contracts, such as cost-plus-fixed-fee government contracts provide that title to property on hand and future purchases passes to the government when the first progress payment is made. Despite the legal title being vested in the government, the taxpayer has an equitable interest in the property to the extent of its net investment. The excess costs will therefore still be included in the property factor.

Costs in excess of progress billings will generally be disclosed in the financial statements either in footnote form or as a separate line item on the balance sheet.

RENTS: CCR §25137-2(d)(4)(B) provides that rent paid for the use of equipment directly attributable to a particular construction project is included in the property factor at eight times the net annual rental rate even though the rent expense may be included in the construction costs.

Payroll Factor:

Compensation paid to employees is includable in the payroll factor even though such compensation may be included in costs of construction that are otherwise not reflected in the factor. Compensation paid to employees engaged in performing services at a construction site is attributed to the state in which the services are performed. This is the case even though the taxpayer will report such compensation to the state where the employees' base of operations is located for unemployment tax purposes (CCR §25137-2(d)(5)).

Sales Factor:

Under the percentage of completion method, the sales factor for each year will include the portion of the gross contract price that corresponds to the percentage of the entire contract that was completed during that year. For example, if the taxpayer completes 30% of a project during the year, and the project had a bid price of \$9,000,000, then the gross receipts includable in the sales factor will be \$2,700,000. Progress billings are not considered under this method. (CCR §25137-2(d)(6)(B).)

If the completed contract method is used, the sales factor will include the portion of the progress billings that were accrued or received during the taxable year. (CCR §25137-2(d)(6)(C).) The sales

factor will therefore reflect the revenue from the contract during the years in which the contract is being performed. This is in contrast to the income from the contract, which will not be recognized until the contract is completed.

Gross receipts derived from the performance of a contract will be attributed to this state if the construction project is located in this state. If the project is located partly within and partly outside the state, the gross receipts will be allocated to this state based on the ratio of construction costs incurred within the state during the taxable year over the total costs for the project. (CCR §25137-2(d)(6)(A).)

Application of Apportionment Formula:

Except as indicated above with respect to the composition of the apportionment factors, no special apportionment computations are necessary for the percentage of completion method. To the extent that the completed contract method is used however, a special formula is described in CCR §25137-2(e).

Under the completed contract method, recognition of income from the contract is deferred until the year in which the contract is completed. On the other hand, the factors representing the business activities that generated that income will have been reflected in earlier years. In order to achieve proper matching between the income and the factors, the formula operates as follows:

Business income from sources other than completed contracts is apportioned in accordance with the apportionment percentage for the taxable year.

For each contract completed during the year, the portion of the gross receipts attributable to each year of the contract (based on the percentage of costs incurred in each year) will be determined. The gross receipts for each year will then be netted with the costs incurred during that same year to derive the contract income or loss attributable to each year of the contract. The contract income or loss for each year will be multiplied by the apportionment percentage for that year. The products are totaled, and the resulting income or loss will be the amount of business income from the contract derived from sources within the state.

The Regulation contains several examples of these computations and audit schedules for these calculations are available on PASS.

Note: The use of the completed contract formula was approved by the SBE in the *Appeal of Donald M. Drake Company* (Cal. St. Bd. of Equal., March 2, 1977). Subsequently, in the *Appeal of J.F. Shea*, the SBE refused to allow application of the formula in a situation where the early years of a contract pre-dated the acquisition of two subsidiaries, resulting in no completed contract income attributable to those years being apportioned to the subsidiaries. The precedential value of the *J.F. Shea* decision is limited to the specific facts present in that case.

The calculations for apportioning income from contracts using the completed contract method can be very time-consuming if multiple contracts are involved. Before adjustments are pursued in this area, the auditor should carefully consider the tax implications. Any approximation of tax potential needs to take into account the fact that the completed contract method may only be allowable for a portion of the contract under the percentage-of-completion-capitalized-cost rules. In general, if all contracts are completed within the same time frame (i.e., two years), additional tax will most likely result from application of the special formula if:

the aggregate of completed contracts is a loss and the apportionment factor is larger in the year being tested than in earlier years;

or

the aggregate of completed contracts is a gain and the apportionment factor is smaller in the year being tested than in earlier years.

If the taxpayer has a few significant contracts, which run much longer than the other contracts, a quick look at the apportionment factors from the earlier years of those contracts will help place the overall tax impact in better perspective.

If the test check reveals that the tax potential of placing a taxpayer on this formula does not warrant the audit time, the decision to forego this issue should be explained in the audit narrative. If application of the formula will result in a refund, and a substantial amount of work would be required to apply the special formula, the taxpayer should be notified in writing and given the opportunity to complete the work. If the taxpayer does not wish to do the work, the audit should be closed and the returns accepted as filed.

If the test shows a material amount of additional tax, the special formula will need to be applied. The information that will be needed to make the adjustments are:

The contracts completed in each year under audit.

The profit or loss on each contract.

The total direct costs of each contract and the year(s) in which they were incurred.

The apportionment factor for each year involved.

Use of the Schedule M-1 as a starting point is generally useful in obtaining supporting data for the above items. Commonly, the taxpayer will have a schedule showing work-in-progress at the end of the year, which will tie to the Schedule M-1. This schedule can be compared to the end of the year for the prior period and any missing contract numbers will be contracts that have been completed in the current year. After identifying the contract numbers, the profit or loss can be determined and a

supplemental schedule showing the direct costs by year should be easily obtained. In many cases, the work-in-progress schedule will show all the data that is needed.

The apportionment factors used for each year should reflect the proper method of reporting. For example, if the taxpayer used separate reporting in earlier years and a combined report was proper, the earlier years apportionment factor will need to be recomputed on a combined basis even if the statute is closed. (No income adjustment, of course, would be made on closed years.) FTBs basis for recomputing income and factors from closed years in the context of NOL carryovers is discussed in MATM 8000.

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7715 FRANCHISORS

CCR §25137-3

The following special rules are provided in CCR §25137-3 for the allocation and apportionment of income of franchisors.

Payroll Factor:

Franchisors will typically employ personnel whose duties include regularly traveling to the franchisees' locations to provide administrative or advisory services. Under the normal payroll factor rules, the compensation paid to such employees would be assigned to the one state in which their base of operations was located (MATM 7370). In accordance with CCR §25137-3(b)(1) however, compensation paid to such employees will be assigned to the numerator of the payroll factor on the basis of the following ratio:

$$\frac{\text{Time spent performing administrative and advisory services at franchisee locations in California}}{\text{Over Time spent performing such services everywhere}}$$

Sales Factor:

Franchisors generally provide various services for their franchisees, for which they receive fees. The regulation provides that fees received for (1) national and regional advertising placed by the franchisor; (2) administrative or advisory services; or (3) site investigation, selection and acquisition of a place of business for a franchisee shall be attributed to the state in which the franchisee's place of business is located. If the taxpayer is not taxable in the state of the franchisee, the receipts shall be attributed to the state in which the principal office of the employee performing the services is located. If the services are performed by an independent contractor rather than by an employee of the taxpayer, the receipts shall be attributed to the state of the taxpayer's commercial domicile.

Fees or royalties received for the use of the franchisor's trademark, trade name, or the right to market a product or service shall be attributed to the state in which the franchisee's place of business is located. If the taxpayer is not taxable in such state, the receipts shall be attributed to the state of the taxpayer's commercial domicile.

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7720 *BANKS AND FINANCIAL CORPORATIONS*

CCR §25137-4.1 and CCR §25137-4.2 (effective for taxable years beginning on or after 1/1/96)

The unique rules developed to deal with the allocation and apportionment of income from banks and financial corporations are covered in detail in the Bank and Financial Handbook. Auditors should refer to that manual if they are auditing taxpayers in this industry.

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7725 COMMERCIAL FISHING**CCR §25137-5**

A special formula has been devised under CCR §25137-5 for commercial fishing boats operating within and outside California waters. The property, payroll, and sales factors attributable to boat fishing activity in California are determined by a "port day ratio." A ratio of California port days to total port days is applied to the total ship property, payroll and revenue for each fishing boat to determine the California portion. This formula only applies to boat activity. Land-based activities such as dockside facilities and equipment, and dockside payroll are assigned to the numerators of the factors under the normal apportionment rules.

A port day is defined as a day or part of a day spent in port or on the seas while the vessel is in operation. A port day will begin when a ship enters an area within which a state has jurisdiction to tax or asserts jurisdiction over fishing. Likewise, a port day will end when the boat leaves that jurisdiction or goes out of operation.

The definition of a state includes a foreign country. Thus, when a boat is on the high seas and not in the territorial waters of any state or foreign country, that time is not counted in the computation of port days. Jurisdictional limits vary by state and country. Countries like Mexico and some Central and South American countries assert a 200-mile limit and claim fishing jurisdiction in that area. Thus, tuna boats which begin and end their voyages in California, but which fish off the coast of Mexico will probably include time spent in both California and Mexico jurisdictions for the port days computation. Some larger tuna boats that fish in the Eastern Pacific may be subject to California jurisdiction at the beginning and end of their voyages, no jurisdiction of any state or country while enroute, and possibly jurisdiction in areas of the possession islands located in the Eastern Pacific Ocean. Port days would be counted while in California waters and while fishing within possession island jurisdiction, but not while enroute.

A boat is considered to be in operation when engaged in pre-voyage and post-voyage activities as well as when it is searching for fish, fishing, or transporting fish. Pre-voyage and post voyage activities include activities such loading, unloading, refueling, provisioning the ship, and minor ship repairs. A boat that has been out of operation will begin being in operation for a voyage when it is manned with a full crew and the vessel is ready for a fishing voyage. It ends being in operation after a voyage when the vessel is unloaded and cleaned, including the preparation of the fish wells to a fish-carrying condition.

A boat is not in operation when it is out of service. Out-of-service time includes, but is not limited to, time while a ship is idle between voyages, time for repairs in shipyards (including drydocking), and time during which a boat is seized by a foreign government and held under restraint pending

disposition of charges alleging violation of such government's law. A boat is also out of service when it is involuntarily waiting to unload. Out-of-service time is not included in the port days.

The denominators of the apportionment factors are computed under the normal apportionment rules. The numerators are computed as follows:

Property Factor: The port day ratio for each boat is applied to the cost of the boat and its equipment to derive the portion attributable to the California numerator. Land-based property, such as dockside buildings and equipment, is assigned to California under normal property factor rules.

Payroll Factor: The port day ratio for each boat is applied to compensation paid to the boat's personnel and fishermen to determine the amount attributable to the California numerator. The payroll of land-based employees is assigned under the normal rules.

Sales Factor: The port day ratio for each boat is applied to total revenues from that boat to determine the amount includable in the California numerator. Other gross receipts are assigned to California using the normal rules.

Local fishing boats generally do not have significant issues in this area because their operations generally will be contained within California's three-mile limit or in waters not subject to a jurisdiction. Such boats would have a port day ratio of 100% to California.

The main audit problems identified in this area deal with long-range tuna clippers that sail from San Diego and San Pedro to fish off Mexico and Central America for yellowfin tuna. San Diego boats may also travel to the Eastern Pacific Ocean area to fish. Typical tuna voyages involve preparing the boat for sailing, traveling to the fishing areas, searching for fish, catching fish, storing the fish in refrigerated holds, and returning to port. The fish is sold to canneries in San Diego, San Pedro, Samoa, Puerto Rico and other locations. Refueling of the boat sometimes takes place at foreign ports. As long as adequate catches are being made, a voyage will usually last as long as it takes to fill the holds (anywhere from a week to two or three months). If fishing is good, a boat may return to port, sell its fish, and immediately depart on another voyage. When fishing is not good or when it is off-season for tuna, the boat lies at dock idle, and is out of operation.

To develop port day information, the auditor must examine the ship's logs and other ship records to know when, where, and for how long a boat is in a jurisdiction area. These records will also show the time spent out of service and the time spent in areas of the ocean not under any fishing jurisdiction. Total port days will only include time that the boat is in operation and under a jurisdiction. Drydock, idle time, and extended repair time are not counted in port days. Once the port day ratio has been developed for each boat, the auditor need only examine the taxpayer's general ledger summaries or other records to determine each boat's revenue, property, and payroll factor amounts. These

amounts are usually segregated by each boat. If not, the taxpayer can be asked to provide such segregation.

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7730 FOREIGN COUNTRY OPERATIONS**CCR §25137.6**

The rules for determining income and factors from foreign country operations were formerly set forth in CCR §25137-6. As of March 21, 1995, the regulation was renumbered CCR §25106.5-3. And once again the regulation was renumbered to 25106.5-10 as of August 12, 1999. For discussion of how particular items of income or factors should be treated by foreign corporations, refer to the sections of this manual, which cover those income or factor issues.

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7735 AIR TRANSPORTATION COMPANIES

CCR §25137-7

The unique formula for air transportation companies was designed to recognize "bridge" states in the apportionment formula. Under the formula, a portion of the income of airlines is assigned to bridge states (the states the aircraft fly over, but do not land in) as well as to the states wherein they make their arrivals and departures. The rules for inclusion of air carrier property in the numerator of the property factor have been codified in R&TC §25101.3. These rules are based on provisions for valuing aircraft within the state for property tax purposes. CCR §25137-7 has since been promulgated to somewhat conform the computations of the payroll factor and the sales factor to the property factor calculation.

For purposes of the special formula, the business of air transportation applies to scheduled airlines, supplemental airlines, and air taxis (see below for application of the rules to air express companies). Aircraft owned or rented by the taxpayer are divided into class types such as DC-10 or L10-11, and the special formula is calculated and applied separately for each type of aircraft.

Property Factor:

Aircraft owned or leased by a taxpayer may be used by another airline under an exchange program. Such exchange transactions do not constitute rentals or subrentals. Such aircraft are to be accounted for in the property factor of the taxpayer owning (or leasing) the aircraft. CCR §25137-7(b)(1)(A)(i)

The value of property assigned to the numerator of the property factor is calculated using the following formula:

Time aircraft spent in the state during the year (both in air and on ground)	(a)
Over	
X	75% = Time Factor

Total time everywhere during the year

	(b)
Number of arrivals & departures from airports within the state during the year	
Over	
X	25% = Arrivals & Departures Factor

Total number of arrivals & departures from airports everywhere during the year

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Sum of (a)+(b)

Multiply by value of owned or rented property in denominator:

X Value

Value assigned to numerator of factor

\$ xxxx

Payroll Factor:

As with the property factor, flight payroll is computed for each class of aircraft. Compensation paid to flight personnel is attributable to this state based upon the ratio that air and ground time spent in this state bears to the total air and ground time spent performing services everywhere. For purposes of this calculation, ground time includes time spent performing pre-flight and post-flight activities, as well as time on the ground at intermediate stops for loading and unloading of passengers, freight, mail, etc. Air and ground time used for training purposes to maintain proficiency of flight personnel shall also be included. The resulting California flight payroll for each class of aircraft is added to the payroll of nonflight personnel in this state to arrive at the California numerator. (CCR §25137-7(b)(2))

Sales Factor:

Aircraft revenue from hauling passengers, freight, mail and excess baggage is generally assigned to this state using a formula similar to the formula described for the property factor, but with the following modifications:

The numerator of the time factor includes airtime only.

The denominator of the time factor includes "block to block" time.

The time factor is weighted at 80% rather than 75%, and excludes time for flight training purposes.

The arrivals and departures factor is weighted at 20% rather than 25%, and excludes arrivals and departures for flight training purposes.

Based upon the above modifications, the numerator of the sales factor is as follows:

Airtime aircraft spent in the state during the year

(a)

Over

X 80% = Time Factor

Total airtime everywhere during the year (block to block)

Number of arrivals & departures from airports within the state during the year (by type of aircraft)

(b)

Over

X 20% = Arrivals & Departures Factor

Total number of arrivals & departures from airports everywhere during the year (by type of aircraft)

Sum of (a)+(b)

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Multiply by total revenue:

X Value

Value assigned to numerator of factor

\$ xxxx

If records of actual revenue by type of aircraft are not maintained, then the total aircraft revenue is segregated into passenger revenue and freight revenue and allocated to aircraft type based upon ton-miles for each type of aircraft. This allocation is described in more detail in CCR §25137-7(b)(3)(B).

Airlines file numerous reports with the Civil Aeronautics Board (CAB) or Department of Transportation that should contain the necessary data to compute the elements of the special formula. The auditor should ask the taxpayer to identify the reports that they are required to file, and request copies of relevant reports to verify the apportionment factor. If the annual statistics necessary for computing the formula are not available, the Regulation contains procedures for using statistics from a "representative period."

Exempt Income:

When dealing with corporations involved in air transportation, auditors need to be aware of R&TC §24320 that exempts income derived from the operation of aircraft or ships by a corporation organized under the laws of a foreign country. In order to qualify for the exemption, the aircraft or ships must be registered or documented under the laws of the foreign country, and the income must be exempt from national income taxes by reason of a reciprocal treaty or agreement between the foreign country and the United States.

Federal law contains a similar exemption under IRC §883, however there are some federal/state differences. Although federal law does not contain the California requirement that the aircraft or ships be registered or documented under the laws of the foreign country, federal law does contain an additional requirement that at least 50% of the value of the foreign corporation be owned by residents of a foreign country meeting the requirements of the statute. Auditors should verify that the taxpayers qualify for the state exemption. Because of the federal/state differences, some taxpayers will qualify for the federal exemption but not the California exemption.

A table summarizing the countries which are known to grant equivalent exemptions for various types of international shipping or aircraft income is contained in Rev. Rul. 97-31, I.R.B. 1997-32, 4, July 22, 1997. Since treaty provisions are subject to change however, the full text of the relevant documents should be consulted if this is a material issue.

Air Express Companies

Overnight air express companies generally operate by receiving packages at points of origin around the country, shipping those packages to a central hub location for sorting by the various destinations, and then delivering the packages to the end destinations. The fee for this service is generally a flat rate rather than a rate based upon mileage. Application of the Air Transportation rules under CCR

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§25137-7 may not result in fair apportionment of income for this industry because it assigns sales to "bridge" states that do not reflect the market for the air express companies. For example, if a package is being shipped from Sacramento to Los Angeles, the air express company may route it through Houston for sorting. The Air Transportation rules would assign sales to each of the states between Texas and California. Since the customer is only contracting for shipment of the package within California, the sales should logically be assigned only within this state. The air express company's activities in Houston and enroute would be taken into account in the property and payroll factors.

If the auditor determines that an air express company's use of the CCR §25137-7 Air Transportation rules results in distortion, then a modification to those rules may be made under the authority of R&TC §25137. A modification that would be appropriate for curing distortion in a typical air express company situation would be to calculate the sales factor by assigning 50% of the revenues from air express companies to the point of origin and 50% to the point of destination. The property and payroll factors for such air express companies may generally continue to be determined in accordance with the provisions of CCR §25137-7.

Reviewed: February 2005

7740 FILM PRODUCERS AND TELEVISION NETWORKS**CCR §25137-8**

Regulations dealing with apportionment issues in the motion picture and television industries were adopted in 1987, effective for taxable years beginning on or after January 1, 1982. Prior to the adoption of the regulations, the department had followed a somewhat similar methodology pursuant to a "Guideline for Motion Picture and Television Film Producers and Television Network Broadcasters Apportionment Formula" that FTB had issued in 1974. To ease past confusion as to how film costs should be included in the property factor however, auditors are to apply the provisions of CCR §25137-8(c)(1)(B)(iii) and (iv) for all open years.

The regulation applies to motion picture and television film producers, producers of television commercials, and to television networks. The regulation will also apply under certain circumstances to independent television stations operating collectively or as network affiliates.

The standard apportionment factors for taxpayers covered under the Regulation are modified as follows:

Property Factor:**RENTED STUDIOS**

If studios are rented, the net annual rental rate shall include only the amount of the basic or flat rental charge by the studio for the use of a stage and other permanent equipment such as sound recording equipment. Additional equipment that is not covered in the studio's basic rental charge or that is rented from other sources shall also be included providing that it is used for one week or longer (even though it may be rented on a day-to-day basis). In the case of a lump sum rental payment covering more than one taxable year, the payment must be assigned ratably over the rental period CCR §25137-8(c)(1)(A)(i).

VALUE OF FILMS

Films are deemed to be tangible personal property pursuant to CCR §25137-8(b)(4). The value of a film is the original cost of producing the film as determined for federal income tax purposes, prior to any adjustments for federal credits, which have not been claimed for state purposes, and will include talent salaries.

Films of a topical nature (including news, current events programs, sporting events, interview shows, etc.) generally have no lasting value, and are expensed for California purposes at the time of production. Such films shall be included in the property factor at their original cost for one year beginning with the release date (the "release date" is defined as the date when it is first telecast or

exhibited to the primary audience for which it was created). If the value of such films is material to the property factor, it may be necessary to calculate a monthly average (see MATM 7125) of the film values in order to more accurately reflect the 12-month inclusion.

All other films are included in the property factor at their original cost for twelve years beginning with the release date.

After the initial one-year or twelve-year period has elapsed, any films for which income has been received during the taxable year shall be aggregated and treated as a single film property. Such property will be valued at eight times the aggregate gross receipts generated by those films during the year, but may not be valued at an amount greater than the total original cost of the aggregated film property.

The value of films will be assigned to the numerator in accordance with the ratio of the total California receipts from those films over the total of such receipts everywhere. The film receipts are determined for this purpose in the same manner as they are determined for sales factor purposes (see below).

TANGIBLE PERSONAL PROPERTY OTHER THAN FILMS

If tangible personal property (other than films) is used within and outside the state during the year, the portion of its value included in the numerator shall be in the same ratio which the number of days the property was located or used in this state bears to the total number of days such property was owned or rented during the taxable year.

Videocassettes and discs intended for home viewing are not considered films under CCR §25137-8(b)(1). Such property shall be included in the property factor at its inventory cost.

Payroll Factor:

The payroll factor includes all compensation paid to employees during the taxable year, including talent salaries. Residual and profit participation payments also constitute compensation paid to employees. In many cases, actors or directors will be employees of personal service or "Alter Ego" corporations, and producers will contract with such corporations to provide the services of the actors or directors. The amounts paid to such corporations for those services, if substantial, will be included in the producer's payroll factor as if it were compensation paid directly to an employee.

Compensation of employees engaged in the production of a film on location must be attributed to the state where the services are or were performed. Compensation of all other employees is determined according to the normal rules.

Sales Factor:

The special rules applicable to the sales factor involve the assignment of gross receipts to the numerator.

FILMS

The numerator of the sales factor should include gross receipts from films in release to theaters and television stations located in this state. Gross receipts from films in release to or by a television network for network telecast shall be attributed to this state in the ratio that the California audience for such network stations bears to the total audience everywhere. Although CCR §25137-8(c)(3)(B) indicates that published rate card values are to be used to determine the audience, those rate card values are no longer published. Alternatives named in the Regulation for determining audiences are other published market surveys, or population data published by the U.S. Bureau of Census. The taxpayer may have internally generated audience information that may be used if it appears reasonable. (Note that most independent radio and TV stations are not subject to this regulation since they operate in localized areas. Therefore, advertising revenues of those stations are assignable to the state where the broadcast originated under the normal rules of CCR §25136. The location of the listening audiences is not considered for these taxpayers.)

Gross receipts from films in release to subscription television telecasters shall be attributed to this state in the ratio that the California subscribers bear to the total subscribers everywhere.

VIDEO CASSETTES AND DISCS

Receipts from sales and rentals of videocassettes and discs are included in the sales factor in accordance with the normal rules for tangible personal property under Regulations 25135 and 25136.

Reviewed: December 2002

7745 RAILROADS**CCR §25137-9**

The special rules for apportionment of railroad companies are found in CCR §25137-9.

Railroad companies are broadly classified by the Interstate Commerce Commission (ICC) into three classes for reporting purposes:

Class I:

Those having annual operating revenues of \$50,000,000 or more. For this class, ICC Annual Report Form R-1 is required to be filed.

Class II

Those having annual operating revenues between \$10,000,000 and \$50,000,000. For this class, Annual Report Form R-2 is filed.

Class III

Those having annual operating revenues of \$10,000,000 or less. For this class, Annual Report Form R-3 is filed.

The Annual Reports filed with the ICC contain some of the data needed to compute the denominator of the special formula, and should be requested by the auditor. The California Public Utilities Commission (PUC) also requires an Annual Report (which is simply a copy of the R-1 or R-2). In addition, a form called State Statistics is required for Classes I and II, and this is the form which will contain the data needed to compute the numerator.

The following terms are used in the Regulations:

LOCOMOTIVES: self-propelled units of equipment designed solely for moving other equipment.

LOCOMOTIVE MILES: the movement of a locomotive a distance of one mile under its own power.

CAR MILES: the movement of a unit of car equipment a distance of one mile.

Property Factor:**TEMPORARY RENTS**

It is common in the industry for railroad cars owned and operated by other railroads to be temporarily used by the taxpayer in its business. The taxpayer will be charged a per diem or mileage charge for the use of those cars. Such payments are excluded from the definition of rents pursuant to CCR

§25137-9(a)(1)(A)(ii), and are not included in the property factor. Likewise, the taxpayer may receive per diem charges for equipment, which they own but temporarily rent, to other railroads. Although the property is temporarily rented out, the original cost of the property is included in the taxpayer's property factor.

MOBILE OR MOVABLE PROPERTY

Mobile or movable property includes property such as passenger cars, freight cars, locomotives and freight containers that are located within and without this state during the taxable year. Locomotives shall be included in the numerator of the property factor in the ratio which locomotive-miles in the state bear to total locomotive-miles. Other railroad cars shall be included in the numerator in the ratio which car-miles in the state bear to the total car-miles everywhere.

The State Statistics filed with the PUC contain data regarding the mileage within California and total mileage (Form SC-931, Statistics of Rail-Line Operations-Within the State). The R-1 or R-2 filed with the ICC discloses the cost of locomotives and cars against which the ratio is applied.

Payroll Factor:

CCR §25137-9(a)(2) provides that compensation paid to enginemen and trainmen performing services on interstate trains shall be included in the numerator of the payroll factor in the ratio which the compensation required to be reported to California for withholding tax purposes bears to the total compensation required to be reported to the IRS. (Under former 49 USC 11504, now 49 USC 11502, compensation of enginemen and trainmen is generally subject to income tax only in their state of residence.)

Sales Factor:**REVENUE FROM TEMPORARY RENTS**

Per diem and mileage charges arising from the temporary use of the taxpayer's railroad cars by other railroads are excluded from the sales factor. This is consistent with the property factor rules that do not recognize such rentals.

REVENUE FROM HAULING FREIGHT, MAIL AND EXPRESS

The portion of the revenue from hauling freight, mail and express that is attributable to this state includes:

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All receipts from shipments which both originate and terminate within this state; and
For shipments passing through, into, or out of this state, the portion of the revenues in the ratio that the miles traveled by such shipment in this state bears to the total miles from the point of origin of the shipment to the destination.

REVENUE FROM TRANSPORTATION OF PASSENGERS

The portion of the revenue from transportation of passengers that is attributable to this state includes:
All receipts from the transportation of passengers (including mail and express handled in passenger service) which both originate and terminate within this state; and
That portion of the receipts from the transportation of interstate passengers (including mail and express handled in passenger service) determined by the ratio which miles traveled by such passengers on the taxpayer's lines within this state bear to the total miles traveled from point of origin to the destination.

The total revenue against which the mileage ratios are applied can be found in the report to the PUC, State Statistics, 5C-210 Railway Operating Revenues Earned within the State.

Reviewed: December 2002

7750 COMBINATION OF GENERAL AND FINANCIAL CORPORATIONS**CCR §25137-10**

Unitary businesses, which are predominantly engaged in financial activities, are subject to apportionment under the rules set forth in CCR §25137-4. Some unitary businesses, however, will contain one or more entities that are classified as financial corporations, but the predominant activity of the business as a whole will not be a financial activity. CCR §25137-10 was added in 1990 to provide special apportionment rules to properly reflect the income of these businesses. The provisions of CCR §25137-10 (as well as the apportionment procedures that were used prior to the effective date of that regulation) are covered in detail in the FTB Bank and Financial Handbook. Auditors should refer to the regulation and to that handbook when examining a combined report that contains both general and financial corporations.

Reviewed: December 2002

7755 TRUCKING COMPANIES**CCR §25137-11**

For years prior to 1991, the Franchise Tax Board had developed a special formula for the apportionment of income from trucking operations. Effective for taxable years beginning on or after January 1, 1991, CCR §25137-11 was enacted to provide the rules for apportioning such income. Since audits of taxable years prior to 1991 are still being performed, both sets of rules will be covered in this section of the manual.

CCR §25137-11 METHOD:

The Regulation applies not only to trucking companies, but also to companies which are not predominantly trucking, but which do conduct some trucking activities. For such companies, the apportionment factors directly related to trucking activities must be separately identified. To the extent that trucking companies also transport goods through methods other than by truck, the property and payroll attributable to such movement shall be assigned to the numerator of the property and payroll factors in accordance with normal rules (or under CCR §25137-7 and CCR §25137-9 if air or rail transportation is involved).

The following terms are used in the regulation:

MOBILE PROPERTY: all motor vehicles, including trailers, engaged directly in the movement of tangible personal property.

MOBILE PROPERTY MILE: the movement of a unit of mobile property a distance of one mile (whether loaded or unloaded).

UNIT OF MOBILE PROPERTY: a single unit of mobile property includes a tractor and trailer, which are connected together for movement.

INTERSTATE RATIO: the ratio that the mobile property miles traveled within this state bears to the total mobile property miles everywhere during the year.

The trucking formula is based upon the interstate ratio. The ratio is computed by aggregating all units of mobile property operated by the taxpayer.

Example: A taxpayer has 10 units of mobile property, all of which operate in more than a single state during the year. One mobile property unit travels 40 miles within California and 60 miles outside the state for a total of 100 miles. The other nine units travel a total of 50 miles each, none of which is within this state. The interstate ratio assigned to California is:
$$40/(100 + (9 \times 50)) = 40/550 = 7.273\%$$

The interstate ratio will be applied to determine the amounts within California for (1) mobile property located in more than one state during the year, (2) compensation paid to personnel which operate and maintain mobile property for services performed in more than one state, and (3) receipts from shipments which originate in one state and terminate in another state.

Mobile property which is located solely within California during the taxable year, and compensation paid to personnel for operating or maintaining mobile property solely within this state are included 100% in the numerator of the property and payroll factors. Likewise, all receipts from any shipments that both originate and terminate within California are included 100% in the numerator. The interstate ratio is not applied to these wholly California items.

The regulation contains a de minimis standard which will not require apportionment to California if: (1) the taxpayer does not own any property in California other than mobile property which operates within and outside the state; (2) the taxpayer does not make any pick-ups or deliveries within the state; (3) the taxpayer does not travel more than 25,000 mobile property miles (provided total mobile property miles traveled within the state does not exceed 3% of total mobile property miles) within the state; (4) and the taxpayer does not make more than 12 trips into the state.

The regulation contains a requirement that the taxpayer maintain the records necessary to identify the mobile property, which operates in more than one state, and the miles traveled by such property in each state. Diesel tax reports filed with the Board of Equalization should also show mileage in and out of California, as should the report filed with the California Public Utilities Commission. The taxpayer will have individual manifests, which can be checked on a test basis.

PRE-1991 RULES:

The formula that the department used prior to the adoption of the current Regulation is authorized under the general authority of R&TC §25137, which allows special allocation and apportionment methods when the normal methods do not fairly represent the extent of the taxpayer's business activity within the state. The old formula operated in a similar manner to the current Regulation, except as follows:

Mobile property and compensation paid to the drivers of mobile property were assigned to the numerators of the property and payroll factors based upon the ratio of "ton miles" in California to ton-miles everywhere. Ton-miles represented truck capacity in tons times the miles traveled. For example, a 20-ton truck driven 100 miles would represent 2000-ton miles. This formula weighted the mileage traveled within the state by the carrying capacity of the trucks. If ton-miles for each truck were not available, trucks were grouped into similar sizes, e.g., 5-ton, 10-ton, 20-ton, etc., and the total mileage for each group would be used to compute ton-miles.

Receipts from interstate trucks were attributed to California based upon the ratio of revenue miles in California to total revenue miles everywhere. Revenue miles represent miles traveled hauling cargo, and exclude any miles when the truck was traveling empty because empty mileage does not generate revenue.

Reports filed with the Interstate Commerce Commission should disclose total ton-miles and revenue miles, and California data may be derived from reports filed with the California Public Utilities Commission.

Department practice had been to apply the above guideline only to interstate trucking activity, and to determine factors from trucking activity carried out solely within the state using the normal apportionment rules. In the *Appeal of United Parcel Service, Inc.*, Cal. St. Bd. of Equal., May 6, 1986, the SBE ruled that the trucking guidelines issued by the FTB did not make any distinction between interstate and intrastate trucks or drivers, therefore the taxpayer was entitled to use the formula for all of its trucks and drivers. This problem was taken care of prospectively in the Regulation through clear language stating that intrastate trucking activities are assigned entirely within this state.

Reviewed: December 2002

7757 PRINT MEDIA**CCR §25137-12**

The apportionment rules under CCR §25137-12 apply to taxpayers in the business of publishing, selling, licensing or distributing newspapers, magazines and other types of printed materials. Such taxpayers derive a large percentage of their revenues from the sale of advertising space, and the regulation clarifies the treatment of advertising revenues in the numerator of the sales factor.

Gross receipts from the sale of printed materials delivered or shipped to a purchaser (or subscriber) within California is included in the numerator of the sales factor in accordance with the normal rules for sales of tangible personal property (see MATM 7520). Gross receipts derived from advertising or from the sale, rental or other use of customer lists is attributed to California based upon the taxpayer's "circulation factor." The circulation factor must be established each year, and for each of the taxpayer's publications, and consists of the following ratio:

$$\frac{\text{The publication's in-state circulation to purchasers and subscribers}}{\text{Over}} \\ \text{Total circulation for that publication}$$

The circulation should be determined by reference to rating statistics as reflected in sources such as Audit Bureau of Circulations. If no satisfactory sources are available, the circulation can be determined from the taxpayer's books and records.

If specific items of advertising can be shown to have been distributed only to a limited region within the total circulation area of the publication, then a regional or local geographic circulation factor should be used in lieu of the overall circulation factor for that publication.

If the purchaser or subscriber is the U.S. government or if the taxpayer is not taxable in a state, then a throwback rule applies. All gross receipts (including receipts from advertising and customer lists) that would have been attributed to the other state by the circulation factor will be included in the sales factor numerator of this state if the printed materials were shipped from a place of storage or business in this state.

This regulation was effective November 3, 1995. For taxable years beginning before that date, similar treatment was required under [FTB Legal Ruling 367](#) (1973).

Reviewed: September 2003

7760 SEA TRANSPORTATION ACTIVITIES**CCR §25101(b)**

The apportionment rules for sea transportation activities are located in CCR §25101(b). For purposes of the special formula, sea transportation means ocean vessels carrying cargo, freight, mail, passengers or similar items. In 1995, R&TC §25101(b) was retroactively amended to clarify that the special formula applies to any sea transportation activity regardless of whether or not the taxpayer's primary business is sea transportation. Commercial fishing activities and vessels that are not engaged in sea transportation are not covered by this regulation, and are discussed in MATM 7725 and MATM 7815.

The property, payroll, and sales factors related to vessels and their employees are determined in part under the concept known as "voyage days." A voyage day is defined as a day, or part of a day, that a ship is in operation for the purpose of transporting cargo, freight, mail, passengers, and the like. The days that a ship is in operation include all sailing days, even though a ship is returning empty or is enroute to a port of call to load passengers or cargo, all days in port while loading and unloading, and all days that the ship is laid up for ordinary repairs, refueling, or provisioning. Voyage days do not include time a ship is out of service or during the time it is laid up for extended repairs, overhaul, modification, or is in drydock.

A California voyage day includes all days from the time a vessel enters the California three-mile limit until it leaves that three-mile limit. Since it is unlikely that vessels of the size contemplated herein would remain continuously within the three-mile limit when sailing between California ports, a portion of the voyage may not be included in California voyage days.

The voyage day ratio is derived by dividing California voyage days by total voyage days. The ratio must be calculated separately for each ship. In calculating the apportionment factors, it is important to note that the voyage day ratio is only applied to property, payroll and sales related to the ocean vessels. Property, payroll and sales not connected with the ships (such as port restaurants, port facilities, land based offices, etc.) are subject to the usual rules of factor assignment.

Property Factor: All property owned or rented by the taxpayer, with the exception of ships, is subject to the normal rules for inclusion in the property factor. The value of each ship is multiplied by that ship's voyage day ratio to determine the value to include in the numerator of the factor.

To the extent that bare boat charters, time charters and similar contracts constitute leases under established guidelines (see MATM 7137), the expense incurred for the charter will be capitalized by eight in the denominator of the property factor. The voyage day ratio will be applied to determine the portion of the capitalized value to include in the numerator. The owners of the ships that are leased

under such contracts are receiving income from a rental transaction rather than from the activity of sea transportation. Therefore, the voyage day ratio will not be applicable to those owners, and the rules described in MATM 7815 will be used. Taxpayers who charter ships under contracts that are determined to be service contracts will not include any value in the property factor.

When examining the property factor of American shipping companies, the auditor should verify that the cost basis of the ships has not been reduced by "capital construction fund" amounts -- see below for an explanation of this issue.

Payroll Factor: The California payroll factor for ocean-going personnel is determined by applying the voyage day ratio to total payroll for such personnel. Land-based payroll is included in the California numerator using the regular payroll rules.

Sales Factor: The numerator of the sales factor is determined by multiplying the California voyage day ratio times the total revenue from transportation related receipts (receipts from cargo, passengers, freight, mail, and the like). All other receipts are assignable to the California numerator using the standard assignment rules.

The main problem encountered in this type of audit is determining the California voyage day ratio and segregating ocean-going property, payroll and sales from land-based factors. Each ship keeps a detailed log, which shows the exact location of the ship shown in hours, minutes, and seconds. California voyage days can be computed from the time each ship enters or leaves the three-mile limit. Taxpayers will probably use the logs to compute voyage days, and the data may be summarized on apportionment workpapers. The workpapers should be requested to help guide the auditor through the information contained on the logs. The logs should also have detail on extended repair and drydock time that must be removed from both total and California voyage days. The auditor should be careful to ensure that only major repair and drydock time has been removed. Ordinary minor repair time, refueling, and provisioning time are not removed.

The taxpayer's general ledger summaries, revenue runs, property ledgers, payroll records, and other records will show the revenues, property, rent expense, and payroll for each vessel. Once this information is verified, the voyage day ratio for each vessel can be applied to determine the California portion. California property, payroll and revenue for nonocean-going or land-based items can be determined using techniques described in other parts of this manual.

Exempt Income: Under R&TC §24320, income derived from the operation of aircraft or ships by a corporation organized under the laws of a foreign country may be exempt from taxation. In order to qualify for the exemption, the aircraft or ships must be registered or documented under the laws of the foreign country, and the income must be exempt from national income taxes by reason of a reciprocal treaty or agreement between the foreign country and the United States.

Federal law contains a similar exemption under IRC §883, however there are some federal/state differences. Although federal law does not contain the California requirement that the aircraft or ships be registered or documented under the laws of the foreign country, federal law does contain an additional requirement that at least 50% of the value of the foreign corporation be owned by residents of a foreign country meeting the requirements of the statute. Auditors should verify that the taxpayers qualify for the state exemption. Because of the federal/state differences, some taxpayers will qualify for the federal exemption but not the California exemption.

A table summarizing the countries, which are known to grant equivalent exemptions for various types of international shipping or aircraft income, is contained in Rev. Rul.89-42, 1989-1 C.B. 234. Since treaty provisions are subject to change however, the full text of the relevant documents should be consulted if this is a material issue.

Merchant Marine Capital Construction Fund: American shipping companies are subsidized to an extent by the federal government. This subsidy involves the taxpayer placing funds in a special account for ship replacement. Under IRC §7518, U.S. citizens that own or lease qualified vessels may establish tax-deferred reserve funds, called capital construction funds, under Section 607 of the Merchant Marine Act of 1936, for the replacement or addition of vessels. Generally, amounts deposited into a capital construction fund are deductible from taxable income, and earnings from the investment of amounts held in the fund are not taken into account. Withdrawals made for the acquisition, construction, or repair of a qualified vessel are "qualified withdrawals" and do not generate income. Nonqualified withdrawals generate income and are taxed in the year they are made.

For taxable years beginning before 1/1/97, California did not conform to these rules, therefore a state adjustment reversing the capital construction fund deduction and restoring the related income should be made. Since the basis of vessels acquired or constructed through fund withdrawals is reduced for federal purposes by the nontaxable fund contributions, federal/state basis differences will also be present. This will create additional state adjustments for depreciation and gain or loss on the sale of the vessels. For property factor purposes, the cost of the property should not be reduced by the capital construction fund withdrawals.

For taxable years beginning after 1996, California incorporates and modifies IRC §7518. California modifies IRC §7518 to reflect California cross-references, the dividend deduction percentage requirements, and California's tax rate. California incorporates the federal provisions that allow United States citizens that own or lease qualified vessels to establish tax-deferred reserve funds, called capital construction funds, for the replacement or addition of vessels (R&TC §24272.5).

Reviewed: February 2005

7765 BUS TRANSPORTATION

The normal rules under CCR §25129(d) for apportioning income from mobile property are based on time spent within and outside the state. Bus lines involved in interstate transportation of passengers and goods do not generate revenue based upon time within a state, but upon mileage traveled. Therefore, the standard formula may not result in a clear reflection of income for such taxpayers. Under the authority of R&TC §25137, the department has developed modifications to the standard formula to reflect the special characteristics of this industry. The modifications are similar to the special rules authorized for railroads (MATM 7745) and trucking companies (MATM 7755).

The normal apportionment rules should be applied to property, payroll and sales not related to interstate busing. Property subject to the normal rules will include stationary assets such as terminals and offices, as well as *intrastate* buses (buses that do not cross state borders as part of their normal activity).

Interstate buses (buses which travel across state borders as part of their normal activity) will be included in the numerator of the property factor in the ratio which miles traveled in California bears to total miles traveled everywhere. The compensation paid to interstate drivers will also be assigned to California based upon that ratio.

Revenue is not generated when the bus is traveling empty. Therefore, the sales factor is calculated based only upon miles traveled while hauling passengers (revenue miles). Empty miles are excluded from the calculation. Revenue from interstate bus trips is assigned to the numerator of the sales factor in the ratio which revenue miles traveled in California bears to total revenue miles traveled everywhere.

Reports, which the bus lines are required to file with the Interstate Commerce Commission, should disclose total miles traveled. Diesel tax reports filed with the Board of Equalization and reports filed with the California Public Utilities Commission should identify mileage in and out of California.

Reviewed: December 2002

7770 FREIGHT FORWARDING COMPANIES

Freight forwarding companies arrange for the shipment of goods by air, sea, rail or truck common carriers, and receive fees for their services. In addition, many forwarders will provide their customers with truck trailers that may be transported by independent highway haulers or rail piggyback services.

When the freight forwarding company does not provide trailers but only arranges transportation by a common carrier, the revenue is generated by the service of making the arrangements. Past experience has shown that the income producing activities of freight forwarders generally take place relatively equally at the points where the shipments originate and terminate. Therefore, in order for the sales factor to clearly reflect the business activities within the state, the department's practice has been to use R&TC §25137 to assign 50% of the revenue from freight forwarding services to the point of origination, and 50% to the point of destination. Some freight forwarders may ship to and from states in which they have no employees or activity, and nexus may not exist in those states. In such a situation, the sales should be assigned to the location where the income producing activity occurred.

Provision of Trailers:

To the extent that the freight forwarding companies provide their own trailers for transporting customer goods, their revenue is a function of the mileage traveled rather than time spent within and outside the state. In order to clearly reflect the activities within this state, the apportionment rules developed for the trucking, rail, sea or air transportation industries (whichever are applicable) should be applied to the property, payroll and sales related to this activity. Although freight forwarders will not generally fall within the definitions of truck, rail, sea or air transportation companies under the regulations, the general authority of R&TC §25137 may be used to permit application of those rules to freight forwarders in cases where necessary to clearly reflect activities within the state.

Unlike trucking and rail companies that will have nexus in all states in which they operate, it is possible that a freight forwarding company's activities within a state may not be sufficient to establish nexus. In such cases, the mileage ratio calculated for freight forwarding companies should exclude miles traveled through states where nexus has not been established.

In *Appeal of John H. Grace Co.*, Cal. St. Bd. of Equal., October 28, 1980, the SBE held that nexus was not established in California when a corporation's only connection with the state was through railroad cars leased by the corporation to industrial companies who in turn arranged for railroad companies to transport their products in those cars. The railroad cars would occasionally pass into or through California. The SBE held that the presence of railroad cars in California, while under the control of the corporation's lessees' bailees, was "too attenuated to satisfy the statutory nexus requirement." As a practical matter, this type of fact pattern will probably not apply to freight

forwarders because they make the transportation arrangements and are therefore not as far removed from the movements of their trailers. In order to determine whether a taxpayer has nexus in a particular state, the auditor should refer to the nexus requirements discussed in MATM 1100.

Reviewed: December 2002

7780 MINING

Taxpayers who derive more than 50% of their gross business receipts from conducting an extractive business activity may be required to use a three-factor apportionment formula (no double-weighted sales). See MATM 7005.

Valuation of depletable or wasting assets in the property factor is an issue for the mining industry, and is discussed in MATM 7210. Federal/state depletion issues are covered in MATM 6080.

Payments that are made for leased mining rights are considered royalties or a similar form of economic interest in the property. For the limited purpose of CCR §25137(b)(1)(B), royalty payments are treated equivalent to rents and are included in the property factor as such (rent expense), reflecting an eight-multiple capitalization rate under CCR §25130 (MATM 7138). To the extent that payments such as lease bonuses are capitalized, they are included in the factor as owned property. (See MATM 7795 for an explanation of lease acquisition costs or bonuses).

Reviewed: December 2002

7785 PRINTERS

An apportionment problem that commonly arises with taxpayers involved in the printing industry is whether to treat printing receipts as sales of tangible personal property (assigned to the state of destination) or as receipts for personal services (assigned to the state where the services are performed).

Printers will generally produce a product in accordance with the customer's specifications, and in many cases the customer will provide the paper used in the printing process. If the printer does not market the finished product for its own account, the issue is whether the printer is merely providing a fabrication service or is in fact selling a tangible personal product.

The determination of the nature of the printing receipts must be made on a case-by-case basis taking into account the taxpayer's facts and circumstances. Paper makes up the highest component cost of the printing process. If the customer supplies the paper and the printer only supplies incidental materials, then the printer will usually be considered to have provided a service.

On the other hand, if the printer supplies the paper, then the determination becomes more difficult. Some factors to consider would include the extent of the activities performed by the printer, the manner in which the parties treated the transactions (copies of the contracts should be requested), and the relative value of the paper and other components as compared to the finished product. An analysis of this issue is contained in *Wm. H. Wise & Co. vs. Rand McNally & Co.*, (U.S. District Court S.D., N.Y.) 195 Fed. Supp. 621 (5/29/61). For additional information that may help in making the determination, see MATM 7522 and MATM 7545.

Reviewed: December 2002

7790 PROFESSIONAL SPORTS

Generally speaking, all the sports income of California-based professional sports teams will be apportioned to California and none of the sports income of non-California-based professional sports teams will be apportioned to California (R&TC §25141). For exceptions to this rule in cases where other states or countries follow a different rule, see R&TC §25141(d). Notwithstanding these provisions, the non-California-based teams are still subject to the minimum franchise tax if they play within the state. These rules are only intended to operate as stated above, and should not be construed as an inference that the unitary concept is being modified or limited. R&TC Section 25141 is effective for taxable years beginning on or after January 1, 1986. Prior to that date, apportionment rules for professional sports teams were contained in former CCR §25137-10.

Reviewed: December 2002

7795 OIL & GAS INDUSTRY

The oil and gas industry is one of the largest and most important segments of the U.S. economy. The importance of the petroleum industry to the economy of the United States has led Congress and California to pass specialized tax laws that are unique to the oil and gas industry. Petroleum industry accounting records have been adapted to the specialized nature of the industry. As a result, an efficient and effective audit of a return with oil and gas investments, transactions, or operations will require some specialized knowledge of the industry and the tax laws involving the industry. Although many of the basic auditing techniques ordinarily used when auditing income, expense items, state adjustments and apportionment factors will be essentially the same in auditing oil and gas operations, the specialized nature of the industry and its accounting records necessitates the use of additional audit techniques that are not common in other industries.

Overview of the Industry:

The exploration, development, and production of oil and gas require enormous amounts of capital. To obtain the funds needed, companies sometimes join together and pool their resources to explore for oil. Large integrated oil companies, as well as small companies and individuals, participate in the exploration, development, and production phase of the oil and gas industry. Many times partnerships are formed to enable outside investors to invest in drilling ventures. The investors may have little knowledge of the oil and gas industry, but are willing to invest funds in risky drilling ventures because of favorable tax benefits and the possibility of large economic benefits.

Primarily because of the extremely large capital requirements, the transportation, refining, and marketing of oil and gas are phases of the industry that are dominated by the large integrated oil companies.

Specialized aspects of the oil and gas industry that are discussed separately in this manual are offshore drilling operations (MATM 7796) and pipeline companies (MATM 7797). Since many oil companies operate shipping lines to transport the oil, they may also be subject to the sea transportation rules discussed in MATM 7760.

State Adjustments:

Although not apportionment issues per se, there are several state adjustments that are unique to the oil and gas industry and that deserve mention in this section. State adjustments for depletion, intangible drilling and development costs, and tertiary injectants will be present in most cases, and are discussed in MATM 6080, 6085 and 6086. Prior to 1987, state adjustments with respect to exploration expenses may also be necessary (former § 24837, 24837.5).

A material issue for the oil and gas industry involves the deduction for foreign taxes. R&TC Section 24345 generally allows a deduction for taxes paid or accrued during the taxable year, but an exception is made for taxes on or according to or measured by income or profits (see MATM 6100). Many oil-producing countries impose a tax, which is in part an income tax, and in part a compulsory payment in exchange for a specific economic benefit. Such taxes are termed "dual capacity" taxes. Since dual capacity taxes consist of two distinct elements, those elements are separated under rules set forth in CCR §24345(c) in order to determine the portion of the tax that is deductible.

In order for a taxpayer to deduct any portion of a dual capacity tax, the burden is upon the taxpayer to prove (1) that the imposition of the foreign tax is directly related to the receipt or future receipt of a specific economic benefit from the foreign country, and (2) the amount (if any) that is not an income tax. This may be accomplished if the taxpayer claiming a deduction establishes, based on all relevant facts and circumstances, the specific amount of the dual capacity tax that is not an income tax.

Alternatively, the Regulation provides for a safe harbor method. Under the safe harbor method, the taxpayer makes an election on its California return with respect to the foreign country, which asserted the tax upon an entity included in the combined report, and applies the safe harbor formula to determine the deductible portion of the tax. In very general terms, the safe harbor formula operates as follows:

Step 1

Some payments to foreign governments are calculated based upon the "posted" price of crude oil. Since the oil is sold at the market price, the posted price is not representative of realized income to the extent that it exceeds the market price. Therefore, the portion of the payments that are attributable to the differential between the posted price and market price cannot be considered "income" taxes.

The first step in the safe harbor formula is to reduce the actual payments to the foreign government by any payments attributable to a posted price differential (PPD). The method for computing the amount of PPD payments is explained in CCR §24345-7(c)(5)(A).

Payments to Foreign Government	-	Posted Price Differential	=	Non-PPD Payments
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Step 2

A reasonable amount of "income tax" is estimated by multiplying the taxpayer's income in the foreign country by 52% (55% for 1986 and prior).

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated

Income from Activities in Foreign Country	X	52%	=	Amount of Payment Considered to be an Income Tax
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Step 3

Any excess of the non-PPD payments over the portion of those payments that are considered to be income taxes (from Step 2) are added to the PPD payments (from Step 1). The result is the deductible portion of the dual capacity tax.

Non-PPD Payments	-	Amount of payment considered an Income Tax	=	Deductible Portion of Non- PPD Payments (not less than zero)
Deductible portion of Non-PPD payments	+	PPD Payments	=	Total Deduction Allowed for the Dual Capacity Tax

These steps are an over-simplified summary of the mechanical rules described in CCR §24345-7, and the auditor should refer to that regulation if issues arise in this area.

Property Factor Issues:

LEASE ACQUISITION COSTS - The lease acquisition costs are costs incurred in connection with acquiring an oil and gas lease. The initial consideration paid by the lessee to the lessor known as a "bonus" does not represent rents and instead represents an economic interest in the property (Treas. Reg. 1.612-3(a)(3)). These costs are capitalized as part of the cost of acquiring a lease (IRC §178) and therefore should be included in the property factor.

OIL & GAS TANKERS - See MATM 7760, Sea Transportation Companies, for general rules.

ITEMS EXPENSED FOR TAX PURPOSES, CAPITALIZED FOR BOOK PURPOSES. As a general rule, items, which are expensed for tax purposes, are not includable in the property factor (see MATM 7120). Intangible drilling costs (IDCs) are capitalized for book purposes, but are usually expensed for tax purposes. Prior to 1990, auditors should ensure that IDCs have been excluded from the factor if they have been expensed on the return. For taxable years beginning on or after January 1, 1990 however, CCR §25130(a)(1) was revised to include IDCs in the property factor regardless of whether they have been expensed or capitalized. The property factor inclusion is not limited to IDCs incurred after January 1, 1990, but applies to all IDCs that are still capitalized on the taxpayer's books, even though they may have been expensed for tax purposes in a prior year.

If an auditor is unsure whether a cost associated with the development of a well is correctly classified as an IDC, it may be helpful to review the definition of IDCs provided in Treas. Reg. §1.612-4, as well as federal Revenue Rulings and case law on the subject.

GEOLOGICAL AND GEOPHYSICAL COSTS - Geological and geophysical costs, which result in the acquisition or retention of oil properties, must be capitalized as part of the cost of these properties

(Rev. Rul. 77-188, 1977-1 C.B. 76, and Rev. Rul. 83-105, 1983-2 C.B. 51). The average yearly value should be included in the cost value of the property and thus will be includable in the property factor.

In the event that the acquisition or retention of the oil properties does not occur, these costs are deductible as a loss under IRC §165. Since the costs are no longer capitalized, they are not includable in the property factor.

DELAY RENTALS - Generally, oil and gas leases will require the development of an oil property within a set period of time, usually one year. In lieu of abandoning the project if development is not commenced within the contractual period, the lessee may pay the lessor a delay rental, which will extend the period for development. Delay rentals are considered carrying charges which may be expensed, or which the taxpayer may elect to capitalize under the provisions of IRC §266 and R&TC §24426 (Treas. Reg. 1.612-3(c)(2)).

The general rule provides that the capitalized value of expenditures will be includable in the property factor, and no value will be included if the taxpayer has elected to expense the item (MATM 7120). However, if an analysis of the contract reveals that the delay rental is really in the nature of a rent (a payment for the ability to use the land), then the property factor should include eight times the annual rental rate (MATM 7130). Such an analysis need only be performed if the item is material.

ROYALTY PAYMENTS - A mineral lease contract provides that the lessee will make royalty payments to the lessor. The lessor (owner of the minerals) retains a royalty interest in the minerals and is entitled to receive a specific portion of the oil and gas produced or a specified portion of the value of such production. Historically, the typical royalty on oil and gas properties has been a one-eighth share. An amount representing royalties paid in connection with the extraction of natural resources generally is includable in the property factor of the lessee, so long as the property for which the royalty payments are made is actually used by the lessee/taxpayer. The amount to be included in the lessee's property factor is determined by multiplying the annual royalties paid times eight. [FTB Legal Ruling 97-2](#) provides that such royalties shall be treated as equivalents to rental payments. Also, the State Board of Equalization in Appeal of Proctor and Gamble concluded that CCR §25137(b)(1)(B) authorizes the capitalization of royalties in a case such as this.

OFFSHORE PROPERTY - See MATM 7796.

DRILLING SHIPS AND BARGES - Drilling ships and floating barges are included in the denominator of the property factor regardless of location. Vessels operating within the California jurisdictional limits (three miles) are included in both the numerator and the denominator. In the event that the operations of these vessels are conducted both within and outside of the California jurisdictional limits, the value of property to be included in the numerator will be computed on the basis of a modified port day formula (see MATM 7796).

Note: The voyage day formula should not be used as these vessels are not used for sea transportation purposes.

OTHER PROPERTIES - Undeveloped properties, shale oil, tar sands, geothermal steam properties and non-producing leases are all generally included in the property factor as property available for use (see MATM 7140). For the SBE's analysis of this issue, see *Appeal of Richfield Oil Corporation*, Cal. St. Bd. of Equal., November 17, 1964; and *Appeal of Union Oil Co. of California*, Cal. St. Bd. of Equal., November 17, 1964.

Payroll Factor Issues:

PAYROLL ATTRIBUTABLE TO OFFSHORE PROPERTY - See MATM 7796.

OIL AND GAS TANKERS - See MATM 7760, Sea Transportation Activities.

DRILLING SHIPS AND BARGES - See MATM 7796, Offshore Operations.

Sales Factor Issues:

SALES FROM OFFSHORE PROPERTY - See MATM 7796.

ROYALTY INCOME - Royalties received should be included in the sales factor and assigned to the state in which the income-producing activity is located (See MATM 7566). Generally, this will be the location of the drilling operations.

EXCHANGE TRANSACTIONS IN RELATION TO OIL TRANSFERS - To achieve efficient delivery, storage or processing of petroleum, gasoline or similar products, one company may trade its inventory for another company's inventory. Following are examples of such transactions:

Company A ships crude oil-by-oil tanker with its intended destination being Company A's Los Angeles refinery. At some point during the shipment, it is determined that the Los Angeles refinery facilities are full and the oil cannot be delivered for processing. Company B has a refinery that can handle the oil. Company A contracts for Company B to take the delivery and, in exchange, Company B will supply Company A's refinery with oil at a later date.

Company X has crude oil in Texas. Company Y has crude oil in California. Company Y, a dealer in crude, needs oil in Texas to fill a contract for delivery to a customer in that state. Arrangements are made with Company X to exchange its crude in Texas for Company Y's crude in California.

In both instances, there is an exchange of inventory for inventory. These transactions have the potential to distort the sales factor because the exchange does not reflect a true market for the

product. If the value of the inventory is included in the sales factor as a result of the exchange, a double counting of sales will result when the replacement inventory is subsequently sold. If the auditor determines that the inclusion of the exchange transactions in the sales factor is distortive, the exchanges may be excluded under the authority of §25137. See MATM 7701 for a discussion of when application of the standard formula will be deemed to be distortive.

Reciprocal agreements are sometimes entered into whereby Corporation A agrees to buy inventory from Corporation B at a specific location for a specified cash amount in exchange for an agreement by B to purchase inventory from A at a different location. Such arrangements are essentially exchange transactions, and should be given the same treatment as described above. Such transactions may or may not be identified as exchange transactions on the taxpayer's books of account or workpapers, and therefore may be difficult to identify. The auditor may be able to determine whether such transactions exist by interviewing taxpayer personnel familiar with the overall operations of the integrated production process.

SALES OF TRADING COMPANIES OR BROKERS - Oil companies may have subsidiaries which are trading companies or brokers. The function of these subsidiaries is to find buyers for the company product. They may either receive a commission or they may actually purchase and resell the product. When a combined report includes a trading company or broker that purchases and resells the product, the auditor should consider the propriety of including the "gross receipts" in the sales factor. The trading company or broker will typically only have a few employees and minor facilities, and may have less than a one percent profit margin since it is effectively only taking a commission for finding a buyer for the product. The size of the receipts may therefore be disproportionate to the activity conducted. If the auditor determines that the inclusion of the gross receipts in the sales factor is distortive, then an adjustment may be made under the authority of R&TC §25137 to include only the gross profit. For guidance in resolving this issue, see *Appeal of Pacific Telephone and Telegraph Company*, Cal. St. Bd. of Equal., May 4, 1978; and *Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, Cal. St. Bd. of Equal., June 2, 1989; also MATM 7701.

EXCLUSION OF ROYALTY PAYMENTS FROM THE SALES FACTOR - Companies which pay royalties to a landholder or to the holder of an overriding royalty interest sometimes reduce their sales by an amount equal to the royalty payments. For example, if an oil producer has \$800 receipts on which it owed a one-eighth royalty to the landholder and a one-eighth royalty to the holder of the overriding interest, it may record \$600 as sales, and record the remaining \$200 as payables. For purposes of administrative ease, the department will allow the sales to be reduced by the royalties for sales factor purposes so long as that treatment is used on a consistent basis. Since the statute requires the use of gross receipts however, that treatment should only be allowed when the amounts involved are not material.

Reviewed: September 2003

7796 Offshore Drilling Contractors

Offshore drilling contractors and builders of oil platforms on the high seas operate in an area over which the U.S. Government has asserted exclusive jurisdiction. The states are prohibited from taxing activity within the federal jurisdiction, either directly or indirectly.

Through the enactment of the Submerged Land Act (43 U.S.C. 1301 et seq.) and the Outer Continental Shelf Lands Act of 1953 (67 Stat. 462, 43 U.S.C. 1331 et seq.), the U.S. Government's exclusive jurisdiction extends to the subsoil and sea bed of the outer continental shelf, and to all artificial islands and fixed structures erected thereon for the purpose of oil exploration, development, removal and transportation. These acts have been interpreted to also cover barges used for the exploration and drilling of the wells ([FTB Legal Ruling 396](#)). For California purposes, the federal jurisdiction covers the continental shelf beyond the three-mile limit.

All business income derived from activities on the Outer Continental Shelf is included in total business income subject to apportionment even though it cannot be assigned to any state. Therefore, property, payroll and sales attributable to offshore activities are included only in the denominators of the apportionment factors. By excluding Outer Continental Shelf factors from the numerators, income attributable to the Outer Continental Shelf will not be taxed by California because it is being assigned to a location outside the state. Similar inclusion of Outer Continental Shelf income in the unitary tax base has been approved by the U.S. Supreme Court in *Shell Oil Company vs. Iowa Department of Revenue* (488 US 19, 102 L Ed 2d 186, 109 S Ct 278) as not amounting to extraterritorial taxation. California's apportionment rules detailing the treatment of offshore property, payroll and sales may be found in [FTB Legal Ruling 366](#).

Some have questioned the alleged inconsistency between the state's taxation of income earned through activities in the Outer Continental Shelf (OCS) and income earned through exempt activities. For example, cooperatives are taxable on nonmember income only. The department apportions the nonmember income using the apportionment factors that relate to the nonmember income. Member income and apportionment factors are not taken into account to apportion nonmember income.

The US Supreme Court held in *Shell Oil Company vs. Iowa Department of Revenue*:

"In sum, the language, background, and history of the OCSLA leave no doubt that Congress was exclusively concerned with preventing the adjacent States from asserting, on the basis of territorial claims, jurisdiction to assess direct taxes on the OCS. We believe that Congress primarily intended to prohibit those direct taxes commonly imposed by States adjacent to offshore production sites: for example, severance and production taxes. See *Maryland vs. Louisiana* (451 US, at 753, n. 26) ("It is clear that a State has no valid interest in imposing a

severance tax on federal OCS land"). This prohibition is a far cry from prohibiting a State from including income from OCS-derived oil and gas in a constitutionally permissible apportionment scheme."

The difference in treatment for apportionment purposes of income earned in the OCS and exempt income is justified based on the difference in law between an exemption from direct taxation and an exclusion from the tax base.

Property and payroll attributable to offshore activities may only be included in the numerators of the apportionment factors if they are located within three miles of the California coast.

Barges and similar vessels that are used in offshore drilling operations may travel from one offshore location to another. Property, payroll and sales attributable to these vessels should be assigned to the numerator based upon a modified version of the "port day" ratio. As described in MATM 7815 (and MATM 7725), the standard port day formula only takes into account time spent within the jurisdictional waters of a state or foreign country. This results in 100% of the income from the vessels being taxed to those jurisdictions. In order to accomplish the assignment of income to the federal waters on the Outer Continental Shelf, the denominator of the port day ratio must be modified to include time spent in those waters. Sales are also excluded from the numerator unless they take place within the three-mile limit. In order to determine whether the sales factor has been properly computed, it is important for the auditor to obtain an understanding of where the offshore drilling sites are located and how the oil is sold. The oil may either be pumped from these locations through pipelines to mainland refineries or placed directly in tankers for delivery to refineries. The sales may occur at the well site or at a mainland or refinery location. Once the auditor has determined how the oil is sold, the usual rules for assignment of tangible personal property will apply. For example:

If the well site is within the California three-mile limit, then sales of oil at the well site are California sales. If the well site is outside the three-mile limit, the sales are excluded from the numerator. If the oil or gas is pumped ashore to California from outside the three-mile limit for sale to a California customer, the sale is included in California's numerator. Oil in transit to a California location would also be considered California property includable in the numerator of the property factor (CCR §25129(d)).

If the oil or gas is pumped ashore to California for storage and subsequent sale, the subsequent sale would be treated as a sale of tangible personal property shipped from California.

The taxpayer should have records identifying the locations of offshore drilling sites. The annual reports or SEC Forms 10-K might also have this information. The auditor's primary concern should be to identify whether any of the offshore locations are within the three-mile limit off the California coast.

See MATM 7815 for rules regarding the property factor treatment of vessels that spend time both within Outer Continental Shelf areas and within the three-mile limit.

Reviewed: February 2005

7797 Pipeline Companies

Property Factor:

Determining the property to be included in the denominator of the property factor should pose no special problems beyond those encountered in a standard apportionment audit. Pipelines are included in the denominator at original cost, including any portions of the pipelines that run to offshore drilling platforms located outside the three-mile limit.

Interstate pipelines are included in the numerator as shown in the following calculation:

$$\begin{array}{rcl} \text{Pipeline Mils in California} & & \\ \text{Over} & \times & \text{Original Cost of} \\ & & \text{Pipeline} \\ \text{Pipeline Miles} & & \\ \text{Everywhere} & & \end{array}$$

With respect to pipelines running from offshore oil platforms, pipeline miles that run within the three-mile limit are considered pipeline miles in California.

Sales Factor:

Revenue derived from an interstate pipeline will be assigned to California based on a ratio of the barrel miles transported within California to the total barrel miles. If natural gas were transported through a pipeline, the means of measurement would be in cubic feet of gas.

Example: An interstate oil pipeline is 1,000 miles long and has one million barrels of crude oil transported through it during a taxable year. Those barrels of oil travel through 200 miles of the pipeline located within California. One-fifth (200/1000) of the revenue earned by the pipeline from the transportation of oil would be assigned to the numerator.

All revenue earned from a pipeline located entirely within California should be assigned to the numerator. The barrel miles traveled through wholly California pipelines should not be aggregated with the barrel miles of an interstate pipeline.

The auditor should examine I.C.C. and P.U.C. reports to determine the number of barrels of oil or cubic feet of gas that travel through California and through the total length of the pipeline.

Reviewed: December 2002

7800 STOCKBROKERS

Stockbrokers present some unique apportionment problems. The property and payroll factors are calculated under the normal rules, but the department's practice has been to apply special sales factor procedures to a stockbroker's commission income. The sales factor issues for stockbrokers are as follows:

COMMISSION INCOME

Commission income is generated from the buying and selling of stocks or bonds for a customer's account. The stockbroker never actually takes title to the stocks or bonds, but merely earns a fee for arranging the transaction.

STOCKS

Most of the large stockbrokerage firms are headquartered in New York with branch offices around the country. When a customer orders a transaction from one of the branch offices, the resulting revenue is attributable not only to the activity of the sales personnel in that office, but also to the fact that the order is traded on a stock exchange. The normal sales factor rules for assignment of receipts from intangibles would assign all of the receipts to the state in which the greatest proportion of the income producing activity occurred. In order to more clearly reflect income, FTB instituted a practice of attributing 60% of commissions from the buying and selling of stocks to the state in which the originating office is located, and 40% to the state where the exchange is located. Under these rules, commissions from transactions that originate in California branch offices are assigned 100% to California if they are consummated on the Pacific Stock Exchange or if the transactions were not conducted on any exchange. Otherwise, only 60% of the commissions will be assigned to this state. The taxpayer's records will generally segregate revenue by originating office and by how the transaction was consummated.

BONDS

Following the same general rationale as explained above with respect to stocks, commissions from bond transactions that involve an underwriter will be assigned 50% to the state of the originating office, and 50% to the state where the underwriter is located.

COMMISSIONS VS. GROSS RECEIPTS

In addition to arranging transactions for a commission, many stockbrokers will also engage in trades as a principal or underwriter. In such transactions, the taxpayer will purchase securities on its own account for resale. Although the net profit on the resale of the securities is comparable to the commission that would have been received from a brokerage transaction, the gross receipts from the resale will be much greater because they will include the cost of the underlying security. Since most "dealer" transactions take place in the headquarters offices in New York, inclusion of the gross receipts in the denominator of the sales factor has the potential to skew the factor to divert income out

of California. In the *Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc.* (Cal. St. Bd. of Equal., June 2, 1989) the department attempted to correct this problem by requiring the taxpayer to use gross profits rather than gross receipts to reflect these transactions. The SBE did not allow that deviation from the standard formula, stating that FTB had not met their burden of proving that distortion existed. (This case is described in more detail in MATM 7701). As a result of this decision, auditors should allow taxpayers to include gross receipts from dealer sales in the sales factor unless it can be *clearly and persuasively established* that such inclusion would not fairly reflect the taxpayer's activities in California.

Note: The 60/40 and 50/50 splits discussed above *only* apply to the assignment of commission income. The splits do not apply to gain from the sale of securities, interest income, or any other type of income. Gross receipts from the sale of securities should be assigned in full to the state in which the greatest proportion of the income producing activity was performed. For a discussion of what to consider in determining where the income producing activity took place, see MATM 7560.

INTEREST & DIVIDEND INCOME

In addition to the above types of income, stockbrokers will generally have substantial amounts of interest and dividend income. Such income should be assigned to the location where the income producing activity was performed in accordance with the normal rules under R&TC §25136. In order to determine whether an identifiable income producing activity exists and where such activity takes place, the auditor will need to obtain a clear understanding of how each item of intangible income is generated. Some general tips for examining this issue are described in MATM 7560 - MATM 7564. MATM 7560 also discusses the SBE decision in *Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc.* (Cal. St. Bd. of Equal., June 2, 1989) where margin interest of a brokerage was determined to be assigned to the state of the originating office.

RENT EXPENSE IN THE PROPERTY FACTOR

If rent expenses incurred for ticker tape machines and display boards are material to the property factor, auditors should ensure that they have been included correctly. Generally, such rental expenses will include two elements. A portion of the payment will represent the rental for the machine itself, and this portion is properly capitalized by eight and included in the property factor. The other portion of the payment represents a charge from the particular exchange for the quotation information. This latter charge is a service, and should be excluded from the factor.

Reviewed: December 2002

7805 TELECOMMUNICATIONS COMPANIES**Communications satellites:**

Communications satellites located in space are included in the denominator of the property factor in accordance with the normal rules. If the satellite system is directly or indirectly connected to facilities located in California, then satellites will be included in the numerator based upon the ratio of the value of property in California (excluding satellites) to the value of total property everywhere (excluding satellites). For sales factor purposes, the revenues will be included in the numerator based upon the ratio of income producing activities in this state to income producing activities everywhere. The following California Court of Appeals decision contains the authority for this treatment, as well as an example of a sales factor ratio that was considered to be a reasonable measure of the income producing activity.

In *Communications Satellite Corp. v. FTB*, (1984) 156 Cal.App.3d 726, the taxpayer was an operator and part owner of a global commercial communications satellite system. The satellites were in "synchronous" orbit so that they appeared to remain stationary over a fixed point on earth. They were positioned over the Atlantic, Pacific and Indian Oceans, and never passed over California. The system also included earth stations, one of which was located in California. Revenues were generated from the leasing of "half circuits" to communications common carriers. A half circuit is a two-way communications channel between a satellite and an earth station. When combined with another half circuit between the satellite and another earth station, this channel permitted communications to be transmitted between earth stations. The system operated as follows: (1) A communications signal destined for a foreign country or an offshore U.S. point is received at the California earth station from its place of origin in the U.S. through terrestrial facilities owned and operated by communications carriers; (2) The earth station transmits the signal to a satellite in orbit, which in turn transmits the signal to another earth station in a foreign country or an offshore U.S. point; (3) Likewise, communications from foreign countries are received via satellite by the California earth station and are then transmitted to their point of destination in the United States.

PROPERTY FACTOR

The taxpayer only included the California earth station in the numerator, and excluded the value of their interest in the satellite. On audit, FTB included a portion of the value of the taxpayer's interest in the satellite based on the ratio of the value of the taxpayer's interest in property on the ground in California over the value of the taxpayer's interest in property on the ground everywhere. The Court of Appeal agreed with the FTB's treatment, and concluded that there is "an invisible, but apparently continuous and very real connection between the earth station and the satellites. The earth station has a value only because this connection exists, and it is otherwise of no value." Because the taxpayer owned an interest in the satellites, and because the satellites functioned in California at and

through the California earth station, the Court held that they were tangible personal property owned and used in this state within the meaning of R&TC §25129.

SALES FACTOR

In addition to revenues from the leasing of half circuits, the taxpayer also reported its share of the income from the joint venture that owned the satellite system. The joint venture's revenues consisted of use charges paid by the participants. For numerator purposes, the taxpayer had only included a "ground percentage" of sales attributable to the California earth station. This formula resulted in revenues from the use of satellites being omitted from the numerator of any state. FTB revised the numerator computation to include a percentage of sales everywhere based upon the ratio between the number of half-circuits leased at the California earth station and the number of half circuits the taxpayer leased everywhere. Since the revenue from both the leasing of half circuits and from the share of joint venture income are intrinsically related to the function of the earth stations, the SBE upheld the FTB's calculation as reasonable.

NOTE: The method described in the *Communications Satellite* case differs from the treatment used in the *Appeal of American Telephone and Telegraph Company*, Cal. St. Bd. of Equal., June 29, 1982. The department no longer follows the *American Telephone* SBE decision.

International Transmission Cables:

International transmission cables that cross the high seas are similar to satellites in that they are located (at least in part) outside the jurisdiction of any country, but have value only because of their connection with land-based facilities. Therefore, the department's policy is to apply the "Comsat" method for assigning the value and revenue from such assets to the property and sales factors. Use of this method for the apportionment of non-jurisdictional communications satellites was approved by the California Court of Appeals in *Communications Satellite Corp. v. FTB*, (1984) 156 Cal.App.3d 726 (discussed above). As applied to transmission cables, the formula will operate as follows:

Property Factor: All property is included in the denominator of the property factor under normal valuation rules. Property and cable located within California's three-mile limit will be included 100% in the numerator. The portion of the cable that is located beyond the Outer Continental Shelf will be included in the numerator based upon the ratio of property factor values in California (excluding non-jurisdictional assets) to total property factor values everywhere (excluding non-jurisdictional assets).

Sales Factor: For sales factor purposes, the revenues will be included in the numerator based upon the ratio of income producing activities in this state to income producing activities everywhere. In order to construct a reasonable ratio, the auditor should obtain an understanding of how the income producing activity is conducted. Interviews with taxpayer personnel who are familiar with how the revenues are generated will usually be a good source for this information.

Telephone Companies:

Other than the problems discussed above with respect to communications satellites and international transmission cables, telephone companies do not present any unique property or payroll factor issues. The difficulties that arise in apportioning income from this industry generally relate to the sales factor. The department's position is as follows:

Revenues from intrastate calls (calls between two California points) will be included 100% in the numerator of the sales factor.

Revenues from interstate and international calls will be included in the numerator based upon California net plant facilities used in the call to total net plant facilities used in the call. The rationale for this position is that the operation of the facilities constitutes the income producing activity that generates the revenue. The value of the net plant facilities is the best measure of this activity. Since the "all or nothing" approach provided by the normal rules under R&TC §25136 would not reflect the fact that a market exists at both ends of the telephone call, this allocation is made under the general authority of R&TC §25137 in order to fairly reflect the activities within the state.

When auditing a telephone company, the auditor should request a copy of the reports required to be filed with the Federal Communications Commission (FCC). Such reports will contain information regarding plant values and revenues that will be useful for verifying the apportionment factors. Some blank FCC forms are available on the Internet at <http://www.fcc.gov>. Auditors may scan the forms and instructions in order to determine the type of information that is reported and the titles of the forms or reports that they want to request from the taxpayer.

Contributions in Aid of Construction:

Contributions in aid of construction (CIACs) are amounts that are received by a utility company to encourage the provision of services to or for the benefit of the person making the contribution. An example of CIACs occurs when new housing developments are started. The utility companies servicing the area will collect a one-time fee from the developers or homeowners to fund construction of facilities to provide power to the new homes. If the ratepayers consume enough power to pay for the construction, then the fees will be refunded. If sufficient power is not consumed, the utility company will keep the fees.

R&TC Section 24324 provides that CIACs are excluded from the gross income of regulated public utilities that provide electric energy, gas, water or sewerage disposal services. This exclusion does not extend to telephone companies. Cases have been noted, however, where telephone companies

have attempted to exclude such income. If the return contains Schedule M-1 adjustments or state adjustments deducting net CIACs received, those adjustments should be reversed. (Adjustments may also be necessary to allow additional depreciation if the taxpayer reduced the basis of its assets by the amount of the CIACs that it excluded from income -- former §24554.)

Pursuant to R&TC §24325, CIACs made on or after January 1, 1992 will no longer be excluded from the income of any public utility.

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7810 TIMBER

The problem unique to the timber industry is that of valuation of timber tracts in the property factor. CCR §25130(a)(1) provides that owned property shall be valued at its original cost, which is generally federal basis at the time of acquisition, adjusted by any capital improvements and partial dispositions. With respect to timber tracts, the costs are constantly changing as old trees are logged off and new growth takes place. To take the changing value of the timber tracts into account in the property factor, the department interprets the cutting of timber as constituting a partial disposition of the timber property requiring a reduction to original cost basis by an amount equivalent to the depletion adjustment.

An understanding of the basic federal tax treatment versus California's treatment will help the reader to better understand the problem of valuation of timber tracts in the formula and the reasoning behind California's interpretation of original cost for determining the property factor.

Capital Expenditures:

When timberland is purchased, an allocation of the purchase price is made between the land and the timber. The purchase price includes costs of timber cruising, appraisal, land survey, title search and insurance, recording fees, and legal services.

The land account includes the land itself, and depreciable and nondepreciable improvements. Depreciable land improvements include bridges, culverts, graveling, fences, fire towers, and other structures and improvements. Nondepreciable land improvements include earthwork betterments of a permanent character such as clearing, grading, and ditching of roads with an indeterminable life. Permanent roads for administration, fire access or logging are regarded as partly depreciable to the extent that the bridges, culverts, and graveling may be depreciated over their physical life. Temporary roads, which are abandoned after a logging operation has been completed, are usually expensed when cutting begins.

The timber account is divided into three categories: (1) timber for sale (merchantable timber); (2) young growth; and (3) deferred reforestation. The portion of the purchase price of a timber tract, which is attributed to the timber, is allocated to merchantable timber and young growth. These accounts will also include costs of timber cruising and other expenses directly associated with the timber purchase.

The deferred reforestation account is charged with costs of planting timber. These costs include expenditures for the preparation of the timber site for tree planting or seeding and for the cost of seedlings or tree seeds. Site preparation costs include expenditures for tree girdling, brush or stump removal, and the leveling and conditioning of land to facilitate planting. Other expenses capitalized in

this account are tool expenses, depreciation of equipment used in planting and the cost of labor employed in tree planting or seeding.

As timber becomes merchantable, the young growth and deferred reforestation accounts are credited, and such amounts are then debited to the merchantable timber account for recovery through timber depletion.

The federal revenue rulings and case law that clarify the rules for capitalization of timber related costs are applicable for California purposes. To the extent that these expenditures have been capitalized, they will be included in the property factor (net of depletion) as part of the cost of the timber tracts.

Timber Depletion:

For taxable years beginning on or after January 1, 1987, California conforms to the federal rules for depletion of timber tracts (R&TC §24831, Treas. Reg. §1.611-3).

At the time timber tracts are purchased, the total quantity of merchantable timber acquired is determined and expressed in board feet, log scale, cords or other units. The quantity of timber is updated each year to (1) deduct the units of timber that were cut in prior years, (2) add the new units that have been acquired, transferred from new growth accounts or gained by growth, and (3) add or deduct any units necessary to correct the estimate of the number of units available in the account. For each year, the basis (total purchase cost and capitalized expenses, less prior year depletion) allocated to the merchantable timber is divided by the total unit quantity of such timber to determine the unit cost (depletion unit).

The number of units of timber cut during the year multiplied by the depletion unit for that timber account shall be the amount of depletion allowable for the year. To establish the basis of the timber when it is sold, the depletion unit for the year in which the timber was cut will be multiplied by the quantity of timber sold.

In addition to the above rules for depletion, California law contains an election under R&TC §24372.5 by which the taxpayer may amortize certain reforestation expenses over a period of 60 months or more. Although depletion due to the cutting of timber will reduce the value of the timber tracts in the property factor, no such reduction is made for R&TC §24372.5 amortization. The reasoning behind this is that the reforestation amortization is based on time and does not relate to the sale or disposition of the property. Consequently, timber will normally be included in the property factor at its net post-depletion federal basis.

Election to Treat Cutting of Timber as a Sale:

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated

For taxable years beginning on or after January 1, 1987, California conformed to IRC §631(a), which provides an election to treat the cutting of timber as a sale or exchange. In accordance with Treas. Reg. §1.631-1(d)(4), the gain or loss shall be given IRC §1231 treatment (capital gain, ordinary loss) even though the timber might be an inventoriable asset for the taxpayer.

To qualify for the benefits of IRC §631(a), the timber must be cut for sale or for use in the taxpayer's trade or business, and the taxpayer must have owned either the timber or a contract right to cut it for more than one year (six months for property acquired before January 1, 1988). Once the taxpayer makes an election to use IRC §631(a), the election is binding with respect to all timber that the taxpayer owns or has a contract right to cut unless the Commissioner permits revocation of the election.

If IRC §631(a) is elected, the tax effect is as follows:

The cutting of timber is considered to be a sale or exchange of such timber in the taxable year in which it is cut. This provision is based upon the concept of a hypothetical sale of the timber by the taxpayer to itself at the time of cutting.

Capital gain or loss is recognized in an amount equal to the difference between the adjusted basis for depletion of the timber and the fair market value of such timber as of the first day of the taxable year. The fair market value is thereafter considered to be the cost of the cut timber. For example, if the taxpayer is engaged in the manufacture of lumber or other wood products, the fair market value of the timber used to calculate gain at the time of cutting becomes the cost of the timber for purposes of determining the profit or loss upon sale of the lumber or wood product.

The following example will illustrate the application of the above points:

Example: At the start of the taxable year, the taxpayer owned timber with a cost basis of \$16,000 and a fair market value of \$40,000. During the taxable year, all of this timber was cut. The taxpayer therefore realized a capital gain of \$24,000 (\$40,000 less \$16,000). During the same year, the taxpayer sold all the cut timber for \$60,000. The total taxable income from the timber is \$20,000 of ordinary income (\$60,000 less \$40,000) and \$24,000 capital gain income. If no timber had been sold during the current year, the basis of the cut timber for future sales would have been \$40,000.

For taxable years beginning on or after January 1, 1987, California treatment will be the same as federal with respect to calculating income under a IRC §631(a) election. Since this is effectively a deemed intercompany sale and does not reflect the true market for the timber, the deemed sale price from the cutting of timber should not be included in the sales factor. Although the fair market value of the cut timber at the time of the deemed sale is considered the cost of the cut timber "for all purposes for which such cost is a necessary factor," R&TC §25137 may be used to reflect the original cost basis in the property factor (\$16,000 in the above example) in situations where the use of fair market value would be distortive.

Prior to 1987, California had no provisions similar to IRC §631(a). If all the timber was sold in the year cut, no adjustments to income or factor items would be necessary. To the extent that cut timber was not sold, adjustments would be required to back out the IRC §631(a) income and basis adjustments.

Example: Assume the same facts as in the previous example, but assume that the timber was cut prior to California's conformity with IRC §631(a). If none of the timber was sold in the year in which it was cut, \$24,000 of income and sales would need to be removed from the amount reported for federal purposes. In addition, the inventory basis of \$40,000 used for federal purposes would need to be reduced to \$16,000 for the California property factor.

The election of IRC §631(a) for federal purposes should be apparent on Schedule M-1.

Timber Leases and Cutting Rights:

Long-term cutting agreements exist in many forms, ranging from simple purchase-and-sale contracts to more complicated leases or cutting agreements for a term of years with right or license to the lessee to cut and remove the timber. Such agreements may extend to all the timber on the lands covered in the lease, to trees of certain size classes, or to timber yet to be grown if the agreement covers a sufficiently long period.

Most of the timber companies acquire federal cutting rights from the U.S. Forest Service. The Forest Service advertises the amount of timber to be cut and its fair market value for competitive bid. The stated fair market value of the timber includes an allowance for the cost of logging roads in the tract. The successful bidder is typically required to cut the timber within two years after the cutting contract is awarded. Since no payments are made until the logs are sold or delivered to the mill for cutting into lumber, timber companies are required to post a bond for payment of the bid price when the contract is awarded. The Forest Service cutting lease includes a price index escalation clause, which may increase or decrease the bid price of the timber. This adjustment is made at the time the timber is logged, and is based upon the then current price index for each timber classification.

With respect to the lessee, Treas. Reg. §1.631-2(e) provides that payments for timber or timber cutting rights are a capital expenditure and must be treated as part of the lessee's depletable basis for such timber regardless of whether the payments are designated as rentals, royalties or bonuses. The rationale is that rental payments, taxes, fire protection assessments, and other similar payments to or in behalf of the landowner are payments for future growth and not for the use of land. However, there is a split of authority as to the propriety of this regulation (Union Bag-Camp Paper Co. v. U.S. (5th Cir.), 325 Fed. 2d 730; U.S. v. Regan (9th Cir.), 410 Fed. 2d 744.)

The inclusion in the property factor of timber acquired or to be acquired under a cutting contract depends upon the nature of the contract. If the contract provides for the purchase of timber for a lump sum, the contract price of such timber or trees will be included in the property factor. If, on the other hand, the purchase contract is the more typical "pay-as-cut" or "no stated value" contract where the seller is to be paid a stated amount per unit harvested and only for the units harvested, title is not deemed to pass until the trees are cut. (U.S. Forest Service and Bureau of Land Management contracts fall into this class.) Until the trees are cut and the exact purchase price can be determined, costs are generally excluded from the property factor. In *Appeal of The Proctor & Gamble Manufacturing Company, et al.* (Cal. St. Bd. of Equal, 9/26/89) however, the SBE determined that inclusion of a value for the entire timberland was warranted. A determination in this area will require an in-depth analysis of the nature of the agreement and the particular facts and circumstances of the case. For a detailed discussion of this issue, see MATM 7138.

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7815 VESSELS SUCH AS TUG BOATS, BARGES, ETC.

The regulations contain special formulas for commercial fishing boats (CCR §25137-5, MATM 7725) and ships engaged in transporting cargo, freight, mail, passengers or similar items (CCR §25101(b), MATM 7760). Other types of sea-going vessels that are not covered by those regulations are discussed in this section. Such vessels include tug boats that service large vessels that enter or leave a California port; dredges that are used in various harbors for repair work; service and repair boats for ocean oil platforms; research vessels used on the ocean for gathering scientific data; and various other types of vessels.

If a bareboat charter or similar charter is deemed to be a lease (see MATM 7137), then the owner of the ship is receiving income from a rental transaction rather than from the activity of sea transportation. Therefore, the sea transportation rules will not be applicable to that owner even though the ship may be chartered for use in sea transportation. The owner will include the ship in the numerator of the property factor in accordance with the rules described in below.

The property, payroll and sales attributable to the ocean-going activities of these types of vessels will be included in the numerators of the factors based upon a "port day" ratio. A ratio of California port days to total port days is applied to total property, payroll and sales for each vessel to determine the California portion. Additional detail with respect to calculating the port day ratio may be found in MATM 7725.

The use of the port day method is authorized under the general authority of R&TC §25137, and was approved by the California Court of Appeals in *Luckenbach Steamship Co. vs. FTB*, 219 Cal. App. 2d 710. The court explained that the port day method more clearly reflected the taxpayer's activities than the voyage day method (voyage days are used for sea transportation -- see MATM 7760). The voyage day formula operates as if income were attributable evenly to every location through which the vessel traveled. On the other hand, the port day formula recognizes that the greater part of the income producing activity of the vessels occurs at ports rather than at sea. The port day method attributes the income to the ports where the bulk of the income producing activity takes place rather than to the high seas.

In order to determine whether the port day formula will apply, the auditor must first gain an understanding of the types of activities performed by each of the taxpayer's vessels. For example, a tugboat, which guides large ships in and out of harbors, is very localized. If the tug is located in a California port, then no activity is likely to be outside the three-mile limit and 100% of the property, payroll and revenue related to the tug will be assigned to California.

Scientific ships do research in various ocean areas. If such a vessel is based in California and takes a trip for research in water not subject to any state or country's taxing jurisdiction, then all activity is

assignable to California. If the vessel does research in waters subject to Mexico's jurisdiction, then time spent in California ports or within the California three-mile limit would be included in the numerator, and port days in both Mexico and California jurisdictions would be included in the denominator.

Vessels involved in offshore oil and gas operations (except for vessels used for transportation of oil which are subject to the voyage day formula -- MATM 7760) must use a modified version of the port days formula that includes time spent on the Outer Continental Shelf in the denominator. This issue is discussed in MATM 7796.

All the above-mentioned vessels should have logs that detail time, location, and activity of the vessels. In addition, taxpayer's apportionment workpapers, general ledger summaries, and property ledgers will aid the auditor in determining the proper apportionment factors.

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